Decision 02-10-020 October 3, 2002

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the New Regulatory Framework for Pacific Bell and Verizon California Incorporated.	Rulemaking 01-09-001 (Filed September 6, 2001)
Order Instituting Investigation on the Commission's Own Motion to Assess and Revise the New Regulatory Framework for Pacific Bell and Verizon California Incorporated.	Investigation 01-09-002 (Filed September 6, 2001)

INTERIM OPINION REGARDING PHASE 1 ISSUES

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I. Summary

Today's decision concludes Phase 1 of the Commission's triennial review of the New Regulatory Framework (NRF). The purpose of Phase 1 was to consider issues arising from the audit of Verizon California Incorporated (Verizon) that was conducted by the Office of Ratepayer Advocates (ORA).

The parties settled most of the issues raised in ORA's audit report. In general, the settlement requires Verizon to implement new procedures to ensure proper regulatory accounting for affiliate transactions and unregulated activities. The settlement also requires Verizon to submit restated financial reports that reflect many of the financial adjustments identified in ORA's audit report. Today's decision adopts the parties' settlement.

The parties were unable to agree on the ratemaking treatment for the financial adjustments identified in ORA's audit report. Today's decision declines to adopt ORA's proposal to reduce Verizon's rates by $104 million over three years to reflect the financial adjustments, as there is no evidence that ratepayers were adversely affected by the accounting improprieties that underlie the financial adjustments.

Today’s decision also declines to adopt ORA’s proposal to make Verizon’s allegedly excessive earnings subject to refund. Today’s decision finds that while Verizon’s earnings have been extraordinarily high, it is not possible to determine at this time whether Verizon’s earnings were excessive. To resolve this matter, today's decision revises the scope of Phase 3 of this proceeding to include issues associated with Verizon's allegedly excessive earnings.

Today's decision directs ORA to conduct another audit of Verizon and authorizes ORA to hire Certified Public Accountants (CPAs) and other technical experts to conduct the audit. Verizon is directed to pay for the cost of the CPAs

and technical experts hired by ORA, and Verizon is authorized to seek recovery of these costs in its annual advice letter for limited exogenous (LE) factors.

Finally, today's decision declines to adopt Verizon's proposal to revise the Commission's rules governing affiliate transactions because Verizon has not demonstrated a need to change the Commission's rules at this time.

II. Background

A. The Triennial Review of NRF

In Decision (D.) 89-10-031, the Commission replaced cost-of-service regulation for Verizon and Pacific Bell Telephone Company (Pacific) with NRF. Under the NRF adopted in D.89-10-031, rates for individual services were adjusted annually based on the following formula known as the price-cap index:

New Rate = Old Rate x (inflation – productivity +/- Z-factors)

Inflation was measured by the gross national product price index (GNP-PI), productivity was initially set at 4.5%, and Z-factors were other rate adjustments approved by the Commission. Verizon was permitted to petition for reconsideration of the adopted inflation or productivity factors if its earnings fell below a rate of return (ROR) of 8.25% for two years in a row.

NRF included an earnings-sharing mechanism that employed several RORs: a market-based ROR of 11.50%, a benchmark ROR of 13.00%, a ceiling ROR of 16.50%, and a floor ROR of 8.25%. Verizon retained 100% of its earnings up to the benchmark ROR, shared with ratepayers 50% of its earnings between the benchmark and ceiling RORs, and refunded to ratepayers 100% of its earnings above the ceiling ROR.

Services were classified into three categories. Basic monopoly services were classified as Category I services. Discretionary or partially competitive services were classified as Category II services. Fully competitive services were classified as Category III services. The price for each Category I service was fixed except for an annual adjustment equal to the price-cap index. The price for each Category II service could vary within a price ceiling and price floor. The price floor was increased annually by inflation, and the price ceiling was revised annually by the price-cap index. Prices for Category III services were provided the maximum flexibility allowed by law.

In D.89-10-031, the Commission established a triennial review cycle for NRF. The first triennial review resulted in several significant changes to NRF. In D.93-09-038, the Commission eliminated the 50% sharing band for Verizon, reduced Verizon's rates by $53 million, and increased the productivity factor in the price-cap index applicable to Verizon. In D.94-06-011, the Commission increased the productivity factor for Pacific, replaced GNP-PI in the price-cap index applicable to Pacific with the gross domestic product price index, reduced Pacific's benchmark ROR, and allowed Pacific to retain 70% of its earnings above the ceiling ROR, with the remaining 30% refunded to ratepayers.

In the second triennial review, the Commission in D.95-12-052 set the productivity factor equal to the inflation factor, which effectively suspended the price-cap index except for Z-factor adjustments.[1] In the third triennial review, the Commission in D.98-10-026 suspended sharing, continued the suspension of the price-cap index, phased out then-existing Z-factor adjustments, and replaced Z-factor adjustments with a streamlined advice letter process for a limited set of exogenous costs and revenues.

The instant proceeding represents the fourth triennial review of NRF. This proceeding commenced on September 6, 2001, when the Commission issued the

[1] The act of setting the productivity factor equal to the inflation factor has often been referred to as the "suspension" of the productivity factor.

combined Order Instituting Rulemaking (OIR) 01-09-001 and Order Instituting Investigation (OII) 01-09-002 (collectively, "the Order").

The Order divided this proceeding into three Phases. Phase 1, which concludes with the issuance of today's decision, addressed factual issues related to ORA's audit of Verizon. The record developed in Phase 1 may be used in Phase 3 to determine whether and how NRF should be revised. Accordingly, parties could not recommend revisions to NRF in Phase 1 unless the revisions were remedial actions that needed to be implemented expeditiously. Phase 2 will address factual issues related to (1) the audit of Pacific that was conducted by the Telecommunications Division (TD), and (2) how service quality for end-users has fared under NRF. Phase 3 will review and revise, as necessary, the major elements of NRF based, in part, on the record developed in Phases 1 and 2.

Opening testimony regarding Phase 1 issues was submitted on January 22, 2002, by ORA, Pacific, and Verizon. The same parties submitted reply testimony on February 19, 2002. Pacific submitted supplemental rebuttal testimony on February 22, 2002. A pre-hearing conference was held on March 6, 2002, and evidentiary hearings regarding Phase 1 issues were held on March 25, March 26, and April 2, 2002. Phase 1 opening briefs were filed on April 16, 2002, and reply briefs were filed on April 30, 2002.

B. ORA's Audit

ORA conducted its audit of Verizon pursuant to Pub. Util. Code § 314.5, D.94-06-011, D.96-05-036, D.98-10-019, and D.98-10-026. The purpose of ORA's audit was as follows:

- Analyze Verizon's NRF monitoring reports.
- Analyze Verizon's accounting procedures that were established to protect against cross subsidization and anticompetitive behavior.

- Determine whether Verizon and its affiliates are following the Commission's rules for affiliate transactions.
- Determine whether Verizon is properly tracking and allocating costs for non-regulated activities.
- Determine whether non-structural safeguards adequately protect ratepayer and competitor interests with respect to non-regulated activities.

The scope of ORA's audit was limited to the years 1996, 1997, and 1998, although some issues identified in ORA's audit report extended to subsequent years.

ORA submitted its audit report to the Commission on April 30, 2001. In its report, ORA alleged that Verizon repeatedly failed to comply with the Commission's rules for cost allocations, affiliate transactions, and NRF monitoring reports, resulting in Verizon accruing more than $100 million in higher costs and lower revenues. Following the submittal of the audit report, ORA, The Utility Reform Network (TURN), and Verizon engaged in a collaborative process to resolve the issues raised in the audit report. While this effort was largely successful, some contested issues remain.

III. Resolved Issues

A. Background

Pursuant to a ruling issued by the assigned Commissioner, the parties were required to submit a Joint Exhibit that identified and described all the issues in ORA's audit report and stated whether each issue had been resolved or remained in dispute.[2] ORA, TURN, and Verizon submitted the Joint Exhibit on January 22,

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[2] Assigned Commissioner's Ruling Determining the Category, Scope, Schedule, Need for Hearing, and the Principal Hearing Officer for the Proceeding issued December 27, 2001 (Scoping ACR).

2002, concurrently with their Phase 1 opening testimony.[3] The Joint Exhibit identifies 144 issues in the audit report. With the exception of two areas of dispute, all issues were resolved to the satisfaction of ORA, TURN, and Verizon. Salient portions of the Joint Exhibit are contained in Appendix C of this decision.

The Joint Exhibit provides a description of each issue, the positions of ORA and Verizon with respect to the issue, and a reference to the parts of ORA's audit report that address the issue. In instances where an issue is resolved, the Joint Exhibit provides a summary of the resolution, an explanation for why it should be adopted, and a description of what action, if any, is required to implement the proposed resolution. The Joint Exhibit also provides a general description of why the resolution of the issues in the Exhibit is reasonable in light of the whole record, consistent with the law, and in the public interest.

The Joint Exhibit identifies but does not address unresolved audit issues. The unresolved issues were addressed in testimony and hearings, and are considered later in this decision.

B. Summary of the Joint Exhibit

1. Cost Allocations

Several audit issues identified in the Joint Exhibit are recommendations for Verizon to (1) develop policies and procedures for allocating costs between Verizon and its affiliates, and (2) maintain documentation that (i) shows how costs were allocated and (ii) demonstrates that costs were allocated in conformance with the adopted policies and procedures. To resolve these issues, the Joint Exhibit includes a newly developed cost allocation manual (CAM) designed to correct problems found by the audit. To verify compliance with the

[3] The Joint Exhibit was admitted into evidence during the Phase 1 evidentiary hearings as Exhibit 107.

new CAM, the Joint Exhibit requires Verizon to conduct internal audits every three years and to provide internal audit reports to ORA upon request.[4]

Many issues in the audit report pertaining to cost allocations were resolved after Verizon provided additional information. For example, a flaw in a newly implemented accounting system allowed certain costs to remain unallocated among jurisdictions. Based on subsequent information provided by Verizon, ORA concluded that there appeared to have been no over-allocation of costs to California, and that a sharp downward trend in unallocated costs resulting from process improvements obviated ORA's original concern.[5]

2. Affiliate Transactions

Several issues in the audit report concern situations where Verizon was unable to demonstrate that it had complied with the Commission's rules for affiliate transactions. In general, the Commission's rules require Verizon to (1) purchase goods and services from affiliates at the lower of the affiliate's fully distributed costs (FDC) or fair market value (FMV), and (2) sell goods and services to affiliates at the higher of Verizon's FDC or FMV. One such issue concerned Verizon's inability to demonstrate that it had purchased primary interexchange carrier (PIC) management services from an affiliate at the lower of FDC or FMV. The Joint Exhibit resolves this issue by stating that it was not possible to determine the FMV of these services during the audit period of

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4 Joint Exhibit, Issues 1 – 3, 105 – 107, and Attachment A (Cost Allocations Binder).

5 Joint Exhibit, Issues 9 – 11. Similar resolutions were reached with respect to Issue 2 (original adjustment is no longer applicable); Issue 5 (use of gross plant vs. net plant to allocate costs found to be immaterial); Issues 7 – 8 (Verizon agreed to provide information to facilitate the allocation of costs incurred by the Multilingual Service Solutions Center and the Language Assistance Center); Issues 28 - 30 (issues shown to be immaterial); Issues 62 - 63 (original adjustment is no longer applicable); Issues 67 - 68 (issues no longer relevant); Issues 79 - 80 (Verizon charges to an affiliate justified by comparison to an outside vendor); and Issues 100 - 102 (elimination of CAM no longer a concern).

1996 - 1998 because no vendors offered PIC management services at that time. A vendor subsequently appeared in 2000, and Verizon agrees in the Joint Exhibit to amend its contract with the affiliate to purchase PIC management services at the lower of FDC or FMV.[6]

Several issues concern disagreements regarding how FMV should be determined. In the Joint Exhibit, the parties agree that FMV may be determined in a variety of commercially reasonable ways.[7] The parties also agree on the appropriate methods for determining FMV, including catalog listings, Internet information, competitive bids, industry publications, benchmarking studies, sales to third parties, appraisals, and replacement cost.[8]

Additional issues concern instances where Verizon allegedly did not comply with the Commission's rules for affiliate transactions. To facilitate compliance, the Joint Agreement contains a set of guidelines for complying with the Commission's rules.[9] However, the parties could not always agree on when the Commission's rules should apply. For example, Verizon did not perform a market study to determine the FMV for its use of an affiliate's nationwide communications network. Verizon claims that it is unnecessary under the Federal Communications Commission's (FCC's) rules to perform market studies for services purchased from affiliates that meet the FCC's definition of "service company," which is the case here. ORA contends that Verizon must perform

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6 Joint Exhibit, Issues 53 - 56. Issues 34 – 39 involve a similar situation where Verizon was unable to demonstrate that it had purchased switching equipment and software from an affiliate at the lower of FDC or FMV. The Joint Exhibit resolves this matter, in part, by ORA and TURN agreeing that Verizon could not obtain information from the affiliate regarding FDC and FMV because Verizon's interest in the affiliate was below the level of control.

7 Joint Exhibit, Issues 70 - 74 and Attachment B.

8 Joint Exhibit, Issues 88 - 91 and Attachment B, p. 9.

9 Joint Exhibit, Issues 92 - 95 and Attachment B.

market studies as required by the Commission's rules. The Joint Exhibit asks the Commission to resolve this matter.

Finally, many issues regarding affiliate transactions were resolved after Verizon provided additional information to ORA. For example, the audit report alleged that an affiliate had overcharged Verizon $2.5 million in 1998. After the report was issued, Verizon showed that the actual costs were not known until the following year, and that an adjustment of $2.5 million was made in 1999.[10]

3. Financial Adjustments

ORA's audit found numerous instances of costs that lacked proper documentation or were misallocated between Verizon and its affiliates. The following table provides a summary of the financial adjustments agreed to by the parties. Where two numbers are shown, the first represents an adjustment to Verizon's historical intrastate costs, and the second represents the cumulative adjustment to Verizon's intrastate rate base.

[10] Joint Exhibit, Issue 17. The following issues were also resolved after Verizon provided additional information: Issues 26 - 27 (prices charged by affiliate justified by market study); Issues 57 - 59 (prices charged by affiliate justified by 3rd party contract); Issues 64 - 66 (prices charged to affiliate for pole attachments justified by Commission decisions); Issues 75 - 77 (prices charged by affiliate justified by 3rd party contract); and Issues 86 - 87 (prices charged to affiliates justified by additional supporting documentation).

Joint Exhibit Issue No.	Audit Finding	1996 ($000)	1997 ($000)	1998 ($000)	1999 - 2001 ($000)	Total ($000)
Issues 2-3	An affiliate performed an extra time study in 1998 for only one of many factors used to allocate costs, resulting in more costs being allocated to Verizon.	--	--	$1,682	--	$1,682
Issue 6	Verizon was unable to support the I-factor used to allocate certain costs between Verizon and its affiliates. Historical allocations adjusted using the S-factor.	$3,443	$8,255	$8,870	$6,966	$27,534
Issues 7-8	Certain costs allocated between Verizon and its affiliates were not supported by interviews with affiliate personnel.	$1,281	($2,123)	($2,196)	TBD	($3,038)
Issues 12-16	An affiliate used an ROR that was too high when determining what prices to charge in 1996, and too low in 1997 and 1998.	$8,429	($1,014)	($47)	--	$7,368
Issues 24-25	An affiliate allocated too much of its costs Verizon.	--	$1,844	--	--	$1,844
Issues 31-33	Losses incurred by an affiliate improperly allocated to Verizon.	$162	$85	$145	--	$392
Issues 35-36	An affiliate used an ROR that was too high when determining what prices to charge Verizon.	$263 $184	$265 $511	$801 1,088	$798 $2,140	$2,127 $2,746
Issues 43-44	The prices charged by an affiliate did not reflect the affiliate's actual costs.	($50)	$262	$38	$595	$ 845
Issues 84-85	Verizon charged too little to its affiliates.	$11	$324	$195	--	$ 530
Issues 88-91	10% mark-up added to transactions for which there was no information showing that Verizon charged its affiliates the higher of FDC or FMV.	$3	$81	$68	--	$ 152
Total – **Costs:** **Rate Base:**		$13,542 $149	$7,979 $511	$9,556 $1,088	$8,359 $2,140	$39,436 $2,140
Affect on Verizon's Intrastate ROR		0.27%	0.15%	0.20%	1999: 0.17% 2000: 0.03% 2001: 0.00%	--

Verizon agrees in the Joint Exhibit to submit revised financial monitoring reports for the years 1996 – 2001 that reflect the above financial adjustments and to include the above adjustments in future financial reports to the extent applicable. These financial adjustments are also included in ORA's proposed rate reduction that is addressed later in this decision.

4. Access to External Auditor Work Papers

Verizon is required by the FCC to develop and maintain a CAM. The purpose of the CAM is to specify procedures for assigning costs between regulated and unregulated operations in accordance with the FCC's rules. Verizon's compliance with its CAM is examined annually by an external auditor.

ORA was denied access to some of the external auditor's work papers.[11] In the Joint Exhibit, Verizon agrees to institute procedures to ensure that the external auditor's work papers will be available to ORA in the future.

5. Contested Issues that Are Deferred

ORA recommended in its audit report that (1) Verizon submit monitoring reports regarding the extent of local competition in Verizon's service areas and Verizon's market share, and (2) the Commission convene a workshop to develop these reports.[12] ORA also proposed that the Commission adopt a permanent requirement for Verizon to submit the service-quality monitoring reports specified in D.00-03-021. The requirement to submit these reports currently ends in 2004.[13] Verizon opposes all of these recommendations.

In the Joint Exhibit, ORA, TURN, and Verizon ask the Commission to (1) defer to Phase 3 the issues associated with ORA's proposed reporting requirements pertaining to local competition, and (2) defer to Phase 2 the issues associated with the service quality monitoring reports that Verizon currently submits pursuant to D.00-03-021.

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[11] Joint Exhibit, Issues 108 – 109.

[12] Joint Exhibit, Issues 132 - 133.

[13] Joint Exhibit, Issue 134.

C. Position of the Parties

ORA, TURN, and Verizon (referred to collectively hereafter as the "Joint Parties") recommend that the Commission adopt the Joint Exhibit and the resolution of audit issues contained therein. They note that the resolution of certain issues requires further action by one or more of the Joint Parties, such as the submittal of restated financial monitoring reports by Verizon. These actions are specified on an issue-by-issue basis in the Joint Exhibit. The Joint Parties stipulate that no Commission action is required with respect to any of the resolved issues other than adopting the Joint Exhibit.

The Joint Parties represent that the resolution of issues in the Joint Exhibit is reasonable in light of the whole record, consistent with the law, and in the public interest. They note that there was no opposition to the Joint Exhibit, which demonstrates that the Joint Exhibit is reasonable and should be approved. They also state that adoption of the Joint Exhibit would allow the Commission and the Joint Parties to focus their resources on protecting the public rather than unnecessary litigation. In addition, the Joint Parties maintain that because they collectively represent the affected interests, the Commission may conclude that the agreement they reached is in the public interest.

D. Discussion

The primary purpose of Phase 1 of this proceeding is to address issues raised in ORA's audit report. However, the audit report cannot be relied upon in isolation. As set forth in the Joint Exhibit, some issues identified in the audit report were resolved because they are insignificant or no longer relevant. Other issues were shown to have been unfounded. Still others have already been addressed by Verizon or will be addressed to the satisfaction of ORA and TURN.

The Joint Exhibit resolves most of the issues identified in the audit report. While not formally presented as a stipulation, the Joint Exhibit may be treated in a similar fashion. Under Rule 51.1 (e), the Commission may approve a stipulation if it is reasonable in light of the whole record, consistent with the law, and in the public interest.

With one exception, we find that the resolution of audit issues set forth in the Joint Exhibit is reasonable in light of the whole record, consistent with the law, and in the public interest. The one exception concerns the proposal in the Joint Exhibit to address in Phase 2 of this proceeding the issue of whether Verizon should continue to submit the service quality monitoring reports required by D.00-03-021 after the requirement terminates in 2004. We conclude that this matter should be addressed in Phase 3 where the Commission will consider revisions to the NRF monitoring program.

We will adopt the Joint Exhibit with the previously described modification.[14] The adopted Joint Exhibit requires further action by the Joint Parties, such as Verizon's submittal of restated financial monitoring reports. These actions are specified on an issue-by-issue basis in the Joint Exhibit. We will require these actions to be completed in the manner and time frames contemplated by the Joint Exhibit. Consistent with long-standing Commission practice, the adopted Joint Exhibit does not serve as precedent for any future issue involving other parties or other proceedings.

Because the adopted Joint Exhibit is more than 400 pages long, it is impractical to append the entire document to this decision. Accordingly, only the most salient parts of the Joint Exhibit are provided in Appendix C of this decision. We emphasize, however, that we are adopting the entire Joint Exhibit, as modified by today's decision, including those parts that are not appended to

[14] The Commission has broad, plenary power to modify a settlement to ensure that it is in the public interest and consistent with the law. (D.99-12-032, Conclusion of Law No. 2)

this decision. Parties may obtain a complete copy of the Joint Exhibit from the Commission's Central Files.[15] Verizon shall also provide a complete copy of the Joint Exhibit to any person or entity that requests a copy.

Although we adopt the Joint Exhibit, we are troubled by the Joint Exhibit's resolution of several alleged violations of the Commission's rules for affiliate transactions. In general, the Commission's rules require Verizon to:

- Price all non-tariffed assets, goods, and services provided to an affiliate at the higher of Verizon's FDC or FMV.
- Price all assets, goods, or services purchased from an affiliate at the lower of the affiliate's FDC or FMV.
- Prepare market studies to determine the FMV of (i) transactions with an affiliate that exceed, in aggregate, $100,000 per year, and (ii) individual transactions with an affiliate that involve assets, goods, or services valued at more than $100,000.
- Determine FDC as described in the FCC's Part 64, with the component for return on investment equal to Verizon's Commission-authorized ROR.[16]

ORA's audit report establishes a strong case that the alleged violations of the previously identified rules described in Joint Exhibit Issue Nos. 13, 16, 18, 25, 33, 36, 44, and 85 did occur, causing Verizon to incur $13.1 million in higher costs and lower revenues during the six-year period of 1996 – 2001.[17] The Joint Exhibit resolves these alleged violations, in part, by requiring Verizon to submit restated

[15] The Joint Exhibit is contained in Exhibit 107.

[16] Resolution T-15950, issued on December 9, 1996, and Verizon's CAM approved by Resolution T-15950, pp. 4-6.

[17] Appendix B of this decision, sum of Issues 13, 16, 25, 33, 36, 44, and 85. There is no financial impact associated with Issue 18.

financial monitoring reports for 1996 – 2001.[18] Although there is no evidence in this proceeding that ratepayers were directly harmed by the ostensible violations of the Commission's rules, we are concerned that violations amounting to tens-of-millions of dollars appear to have occurred. Parties are encouraged to present proposals in Phase 3B for revising NRF in ways that would deter utilities from violating the Commission's rules for affiliate transactions.

IV. Contested Issues

This section of today's decision addresses two sets of issues in the audit report that the parties were unable to resolve. The first set concerns Verizon's relationship with its affiliate responsible for publishing White Page and Yellow Page directories ("the Directory Affiliate"). The second set concerns what rules should apply to certain types of transactions between Verizon and its affiliates.

A. Excessive Directory Earnings

1. Position of the Parties

a. ORA

During the audit period of 1996 – 1998, Verizon and its Directory Affiliate shared revenues obtained from publishing White and Yellow Page directories. Verizon received 63% of the revenues, which amounted to approximately $147 million to $153 million annually during the audit period.[19]

ORA alleges that the Directory Affiliate reaped excessive earnings from its share of the directory revenues, and recommends that the excessive earnings be imputed for ratemaking purposes. For the purpose of this proceeding, ORA and Verizon agreed to define excessive earnings as all of the Directory Affiliate's

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[18] The Joint Exhibit resolves audit issues "without a determination of the factual disputes underlying those issues." (Joint Exhibit, p. 8.)

[19] Exhibit 103, Volume 5, work papers 2-6, 2-7, and 2-8.

earnings from its directory operations in California that exceeded an ROR of 11.5%. The amount of the alleged excessive earnings was $20.5 million in 1996, $6.2 million in 1997, and $35.6 million in 1998, for a total of $62.3 million. ORA also recommends that the Commission require Verizon to conduct studies to determine a reasonable allocation of revenues between Verizon and its Directory Affiliate.

ORA offers several reasons why the Commission should adopt its recommendations. First, Verizon did not conduct any studies to assess the reasonableness of the revenue-sharing arrangement. Without such studies, ORA believes that the Directory Affiliate's excessive earnings are per se unreasonable. Second, prior to NRF, the Commission routinely adjusted Verizon's rates for excessive directory earnings, and ORA believes the Commission should do so here. Third, Verizon and its Directory Affiliate do not bargain at arms length. ORA states that its proposal would prevent Verizon from using its Directory Affiliate to siphon earnings from Verizon's regulated operations. Finally, ORA argues that its recommendations implement the Commission's rules for affiliate transactions as set forth in the CAM that Verizon filed pursuant to D.91-07-056.[20] ORA asserts that the Commission's rules require Verizon to purchase services from the Directory Affiliate at the lower of the Affiliate's FDC or FMV, and that there is no evidence that the revenue-sharing arrangement complies with this requirement. ORA believes that the imputation of the Directory Affiliate's excessive earnings provides a reasonable proxy for the lower of FDC or FMV.

ORA dismisses Verizon's suggestion that studies conducted over ten years ago demonstrate the reasonableness of the revenue-sharing arrangement. ORA

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[20] The Commission modified and adopted Verizon's CAM in Resolution T-15950, issued on December 9, 1996.

believes that the following passage from D.88-08-061 indicates that Verizon should conduct studies more frequently than every decade:

> We have long maintained that a market test is the best way to review the reasonableness of an affiliate relationship. We believe this is true not just for ratemaking purposes, **but also as an ongoing management tool for utilities to use** . . . We will require that [Verizon] perform a full competitive analysis of its options for directory publishing and submit it to [the Commission] no later than March 31, 1989. (D.88-08-061, 29 CPUC 2d 63, 79. Emphasis added.)

ORA opines that the phrase "ongoing management tool" cannot be interpreted as meaning every 10 years or more.

ORA states that although the FCC has determined that transactions between telephone companies and their directory affiliates are not subject to the FCC's rules pertaining to affiliate transactions, this does not preclude the Commission from adopting ORA's recommendation. According to ORA, the FCC has determined that states have authority to impute directory revenues for state ratemaking purposes.

b. TURN

TURN supports ORA's proposal to impute excessive directory earnings for ratemaking purposes. TURN states that ORA's recommendation is consistent with Pub. Util. Code § 728.2, which requires the Commission to consider directory earnings "for purposes of establishing rates for other services." TURN also believes that ORA's proposal is consistent with D.89-10-031 wherein the Commission found that telephone directories are a unique class of services, developed at ratepayer expense, which have historically contributed substantially to basic rates, and which should continue to do so.[21]

TURN acknowledges that the Commission in D.91-07-056 terminated ratemaking adjustments for directory earnings. However, TURN finds nothing in D.91-07-056 that indicates the Commission intended to abandon its holding in D.89-10-031 that ratepayers should receive a substantial share of directory revenues under NRF.

TURN argues that two recent Commission decisions demonstrate that ratepayers should benefit from directory earnings. In D.01-06-077, the Commission held that all directory revenues and expenses should be included in the determination of sharable earnings.[22] In D.99-05-039, the Commission rejected Pacific Bell's argument that § 728.2 eliminates the need or ability to consider Yellow Page revenues in setting rates for other services.[23]

TURN contends that it is irrelevant that the Commission and the FCC treat directory revenues differently for ratemaking purposes. TURN states that the FCC has specifically recognized that states may have the authority to impute such revenues to regulated carriers, FCC treatment not withstanding.

c. Verizon

Verizon opposes ORA's proposal. Verizon argues that in D.91-07-056 the Commission rejected the exact same ratemaking adjustment that ORA proposes here. Verizon also argues that the Commission has never applied its rules for affiliate transactions to directory revenues.

Verizon observes that the basis for ORA's proposal is as follows:

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[21] D.89-10-031, 33 CPUC 2d 43, 146-147, and Finding of Fact (FOF) 81.

[22] D.01-06-077, *mimeo.*, p. 55.

[23] D.99-05-039, *mimeo.*, pp. 3 - 6.

> No studies were conducted by Verizon during the audit period to show that service was provided at the lower of cost or market or that the [division of revenues] was reasonable. Using [the Directory Affiliate's] earnings as a proxy for costs solves this problem. (Exhibit 106, p. 8.)

Verizon argues that ORA failed to show any relationship between the cost of the services provided by the Directory Affiliate and the Directory Affiliate's earnings that ORA wants to transfer to Verizon. Without such a relationship, there is no basis for ORA's proposal. Verizon believes that ORA's proposal is further undermined by the fact that the revenues Verizon received under the revenue-sharing arrangement were far in excess of any associated costs.

Verizon states that it provided ORA with two studies that show the revenue-sharing arrangement between Verizon and the Directory Affiliate was reasonable. The first study was a “competitive analysis“ that Verizon filed at the Commission in March 1989 pursuant to D.88-08-061. The competitive analysis found that Verizon's agreement with its Directory Affiliate provided a contribution to Verizon and its ratepayers significantly in excess of the companies surveyed. The second study was prepared in 1991 by Greenwich Associates. The purpose of the Greenwich study was to compare agreements between Verizon telephone operating companies and their directory affiliates to those of other telephone operating companies. The study found that the business relationship between the Verizon telephone companies and their directory affiliates was prudent, proper, and consistent with industry practice.

2. Discussion

In this section of the decision, we address whether the "excessive directory earnings" of Verizon's Directory Affiliate should be included in the NRF earnings-sharing mechanism that was in effect for Verizon during 1996 – 1998.[24] Later in this decision, we address ORA's proposal to reduce Verizon's rates by an amount that includes the excessive directory earnings.

In deciding whether "excessive directory earnings" should be reflected in the earnings-sharing mechanism, it is useful to first review the regulatory treatment of telephone directories. Telephone directories have been an integral part of telephone service for nearly a century.[25] Directories were developed at ratepayer expenses and, in return, the earnings from directories were used to offset the cost of providing local telephone service.[26] The historically close association between telephone directories and regulated telephone service continues to this day.[27]

Verizon has conducted its directory operations through an affiliate since 1936.[28] The lack of an arms-length relationship between Verizon and its Directory Affiliate has been a long-standing source of concern to the Commission. For example, in 1969 the Commission held:

> We accept the staff position that the [Directory Affiliate] should not be allowed a greater return on business with [Verizon] than

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[24] The revenues that Verizon received under the directory revenue-sharing arrangement were included in the NRF earnings-sharing mechanism throughout the audit period.

[25] In 1926 the California Supreme Court held that "[a] telephone directory is an essential instrumentality . . . It is as much so as is the telephone receiver itself, which would be practically useless . . . without the accompaniment of such directories[.]" (<u>California Fire Proof Storage Company v. Brundige</u> (1926) 199 Cal 185, 187 –188.)

[26] D.89-10-031, 33 CPUC 2d 43, 146.

[27] D.99-05-039, 1999 Cal. PUC LEXIS 244.

[28] D.75873, 1969 Cal. PUC LEXIS 648, *91.

> the latter is allowed on its other utility business . . . It is immaterial that the [Directory Affiliate] has been formed as a corporation separate . . . from [Verizon] . . . Nothing magical happens in relation to function when corporate papers are filed with the Secretary of State; it is the work and function that an entity performs that determines its regulatory treatment, rather than what lawyers put in incorporation papers. (D.75873, 1969 Cal. PUC LEXIS 648, *99 -*100.)
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> [W]e must maintain the position that a utility, when controlling or performing functions that are an integral part of its service to the public, cannot merely, by a separation in corporate structure of what otherwise would be a functioning department, obtain higher profits than would be available to the utility through its fair rate of return. (D.75873, 1969 Cal. PUC LEXIS 648, *104 - *105.)
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> * * * *
>
> [Verizon] and the Directory Company do not bargain at arms length over the division of directory revenues. The Directory Company is used . . . to siphon profits from [Verizon]. To prevent . . . the Directory Company from making an unreasonable and excessive profit on its business with [Verizon] we will reduce [Verizon's] expenses by $ 720,000 . . . for the test year. (D.75873, 1969 Cal. PUC LEXIS 648, *186 – *189)

The Commission made similar findings in each of Verizon's subsequent general rate cases (GRCs).[29] Thus, in the decades prior to NRF, it was the Commission's practice to impute for ratemaking purposes all of the Directory Affiliate’s earnings from its operations in California that exceeded Verizon's Commission-authorized ROR. The effect of this practice was to reduce Verizon's rates by the full amount of the Directory Affiliate's excessive earnings. This practice continued through the last GRC for Verizon prior to NRF where the

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[29] See, e.g., the following: D.79367, 1971 Cal. PUC LEXIS 1024, *38 - *40; D.83779, 1974 Cal. PUC LEXIS 273, *23; D.87505, 1977 Cal. PUC LEXIS 571, *14 - *15; and D.92366, 4 CPUC 2d 428, 451 - 52.

Commission reduced Verizon's revenue requirement by $9 million to reflect the Directory Affiliate excessive earnings.[30] The $9 million ratemaking adjustment was purportedly reflected in Verizon's initial rates under NRF.[31]

In 1982, the legislature enacted Pub. Util. Code § 728.2(a), which states, in relevant part, as follows:

> [T]he commission shall investigate and consider revenues and expenses with regards to the acceptance and publication of [directory] advertising for purposes of establishing rates for other services offered by telephone corporations.

The Commission has consistently interpreted § 728.2(a) as allowing, if not requiring, the Commission to use directory earnings to offset the cost of providing basic telephone service.[32]

When the Commission established NRF in D.89-10-031, the Commission continued its long-standing practice of imputing excessive directory earnings for ratemaking purposes. In particular, excessive directory earnings were purportedly included in the determination of Verizon's start-up revenue requirement, which had the effect of reducing Verizon's initial rates under NRF. In addition, the Commission held that directory earnings should be included in the earnings-sharing mechanism:

> It is uncontested that local exchange carriers continue to enjoy significant market power in the directory advertising market. We see no reason why shareholders should receive the full benefit of what may largely be monopoly profits. Further, since their directory advertising services are well established, we believe that local exchange carriers will retain sufficient incentives to vigorously pursue this market, even if **excess profits** are shared

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[30] D.88-08-061, 29 CPUC 2d 63, 78, and 163.

[31] D.89-10-031, 33 CPUC 2d 43, 186.

[32] See, e.g., D.99-05-039, D.91-01-016, D.90-09-085, D.89-10-031, and D.88-08-061.

> with ratepayers. Because of the existence of significant market power and because efficiency incentives would not be seriously compromised, **we conclude that Yellow Pages directory services revenues should be subject to a revenue sharing mechanism**.
>
> * * * *
>
> **[W]e conclude that directory advertising services should be included in the basic sharing calculation**…**Because it considers** both past directory advertising service contributions through current rates and **future revenues and expenses through the sharing mechanism**, we conclude that this treatment is consistent with PU Code 728.2. (D.89-10-031, 33 CPUC 2d 43, 146 - 147. Emphasis added.)[33]

In D.89-10-031 the Commission distinguished directory earnings from ratemaking adjustments. As described previously, the Commission explicitly required directory revenues and expenses, which are the same as directory earnings, to be included in the earnings sharing mechanism.[34] In contrast, the Commission made a general determination in D.89-10-031 that most "ratemaking adjustments" should be excluded from the earnings sharing mechanism, and instructed the Commission's Advisory and Compliance Division (CACD)[35] to convene a workshop to examine which specific ratemaking adjustments should be excluded from the determination of sharable earnings.[36] One of the ratemaking adjustments that CACD examined at the workshop was the

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[33] Under the earnings-sharing mechanism established by D.89-10-031, Verizon kept all earnings up to an ROR of 13%, shared earnings 50-50 with ratepayers for earnings between 13% and 16.5%, and returned to ratepayers all earnings over 16.5%. In D.93-09-038, the Commission revised the sharing mechanism so that Verizon kept all earnings up to an ROR of 15.5%, and returned to ratepayers all earnings above 15.5%. The Commission suspended sharing in D.98-10-026.

[34] D.89-10-031, 33 CPUC 2d 43, 147.

[35] The functions of CACD relevant to this decision are now embodied in the Commission's Telecommunications Division.

[36] D.89-10-031, 33 CPUC 2d 43, 186.

traditional adjustment for excessive directory earnings. Under this adjustment, all directory earnings in excess of the utility's authorized ROR were returned to ratepayers in the form of lower rates. Following the workshop, CACD submitted a report to the Commission in which CACD recommended, among other things, that the traditional ratemaking adjustment for excessive directory earnings be excluded from sharable earnings.[37]

The Commission adopted CACD's recommendation in D.91-07-056. In adopting the staff's recommendation, the Commission excluded from sharable earnings the "ratemaking adjustment" for directory earnings, not the earnings themselves. To understand the distinction, it helpful to look at another "ratemaking adjustment" that was also excluded from sharable earnings by D.91-07-056: advertising expenditures intended to enhance Verizon's corporate image.[38] Prior to D.91-07-056, expenditures for image enhancement were excluded from rates. The effect of this "ratemaking adjustment" was that Verizon's shareholders bore 100% of the costs for image enhancement. Thus, when D.91-07-056 excluded the ratemaking adjustment for image enhancement from sharable earnings, the decision was, in effect, <u>including</u> costs for image enhancement in sharable earnings.

A similar chain of events occurred with respect to the ratemaking adjustment for excessive directory earnings. Prior to D.91-07-056, the Commission maintained a ratemaking adjustment for excessive directory earnings under which ratepayers received 100% of excessive directory earnings in the form of lower rates. By excluding this ratemaking adjustment from sharable earnings, the effect of D.91-07-056 was to no longer allocate 100% of

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[37] Exhibit 207.

[38] Exhibit 201, Appendix A, Section 2, pp. 9 – 10.

excessive directory earnings to ratepayers, but to include excessive directory earnings in the determination of sharable earnings in the same manner as Verizon's other costs and revenues. Thus, ratepayers were to share in the Directory Affiliate's excessive earnings to the extent these earnings, when combined with Verizon's earnings from its regulated telephone operations, exceeded the threshold for sharable earnings. The Commission's treatment of directory earnings in D.91-07-056 was consistent with the Commission's determination in D.89-10-031 that directory earnings, but not ratemaking adjustments, should be included in sharable earnings.[39]

With limited exceptions, the Commission has never applied its rules governing affiliate transactions to directory affiliates.[40] Rather, the Commission has treated directory affiliates as if they were a part of the regulated utility. This is perhaps best illustrated by D.93-02-019 wherein the Commission determined that its regulations that require utilities to report significant transactions with their affiliates did not apply to transactions between telephone companies and their "regulated subsidiaries," which were defined as follows:

> "Regulated Subsidiary" means any subsidiary of a utility the revenues and expenses of which are subject to regulation by the Commission and are included by the Commission in establishing rates for the utility. For purposes of this rulemaking only, the Yellow Pages subsidiary of any telephone company which is a local exchange carrier (LEC) is a regulated subsidiary if its net revenues are imputed by the Commission in setting the rates of the LEC. (D.93-02-019, 48 CPUC 2d 163, 173)

[39] Nothing in D.91-07-056 gives any indication that the Commission intended to modify or reverse the clear directive of D.89-10-031 to include directory earnings in sharable earnings.

[40] Exceptions include the following services that Verizon provides to its Directory Affiliate: (i) billing and collection services for monthly advertising changes billed to third parties, and (ii) services relating to the provision of listings. (Verizon Phase 1 opening brief, pp. 23 – 24.)

> A regulated subsidiary is considered part of the utility, and therefore any transactions between a regulated subsidiary and an affiliated entity are considered the same as a transaction between the utility and an affiliated entity and must be reported accordingly. (D.93-02-019, 48 CPUC 2d 163, 174)

Although Verizon's Directory Affiliate is a sister company, not a subsidiary, the Directory Affiliate nonetheless satisfies the definition of "regulated subsidiary" because its net revenues[41] are imputed for ratemaking purposes.

With our regulatory treatment of telephone directories in mind, we now turn to considering to what extent the Directory Affiliate's earnings should be reflected in the earnings-sharing mechanism. As described previously, D.91-07-056, D.89-10-031, and long-standing Commission practice require excessive directory earnings to receive the same ratemaking treatment under NRF as Verizon's other revenues and expenses. No subsequent decision has changed this policy.[42] ORA's proposal, which seeks to impute for ratemaking purposes the Directory Affiliate's earnings that exceed an ROR of 11.5%, reflects the Commission's policy. In contrast, the financial monitoring reports that Verizon has submitted to the Commission since 1996 included none of the Directory Affiliate's excessive earnings, resulting in a significant understatement

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[41] The term "net revenues" is defined by D.93-02-019 as revenues less expenses (48 CPUC 2d 163, 173), which is the same as "earnings." Thus, the term "net revenues" as used by D.93-02-019 incorporated all earnings, including "excessive directory earnings."

[42] In Resolution T-16656, Finding No. 7, issued on June 27, 2002, the Commission held that it has always required Verizon to include directory revenues and expenses in its intrastate ROR. In D.01-06-077, *mimeo.*, p. 55, the Commission held that it is the Commission's policy to include all directory revenues and expenses in the sharable earnings calculation. In Resolution T-16254, *mimeo.*, p. 6 and Finding No. 4, issued on December 17, 1998, the Commission held that Yellow Page revenues are "above the line" for ratemaking purposes. This holding was affirmed by the Commission upon rehearing. (D.99-05-039, 1999 Cal. PUC LEXIS 244, *7 – *8.)

of Verizon's reported ROR. The pre-tax amount of excessive directory earnings improperly excluded from Verizon's financial reports was as follows:

	1996	1997	1998	1999	2000	2001
Directory Affiliate's ROR [1]	20.9%	14.3%	24.9%	27.0%	27.0%	27.0%
Directory Affiliate's Earnings In Excess of 11.5% [2]	$20.5 million	$6.2 million	$35.6 million	$41.4 million	$41.4 million	$41.4 million
Effect of Excessive Directory Earnings on Verizon's ROR [2]	0.398%	0.114%	0.719%	0.894%	0.910%	1.014%

[1] **Source**: Exhibit 103, p. 18-4, and the work paper to revised Exhibit 212 submitted by Verizon via e-mail on June 27, 2002.

[2] **Source**: Revised Exhibit 212, W/P 1.

We will require Verizon to file revised financial monitoring reports for every year beginning with 1996 that reflect all of the Directory Affiliate's excessive earnings from the publication of White and Yellow Page directories as set forth in the above table.[43] Verizon shall continue to file financial monitoring reports that reflect all directory earnings in excess of 11.5% until further notice.[44]

Although we accept ORA's proposal to use an ROR of 11.5% for the purpose of determining excessive directory earnings in this decision, prior Commission decisions suggest that a lower ROR might be more appropriate. In D.89-10-031, the Commission established a "market-based" ROR for Verizon of 11.5%. It is apparently this ROR that was used by ORA to calculate excessive directory earnings. Subsequently, in D.93-08-038 the Commission adopted a

43 Verizon should revise its rate base, as appropriate, to reflect directory earnings. (See, e.g., revised Exhibit 212, W/P 1, column labeled "Intrastate Rate Base Impact.")

44 In Phase 3 of this proceeding, the Commission will address the regulatory treatment of Yellow Page revenues. (Scoping ACR, pp. 4-5.) Today's decision in no way prejudges the Commission's decision on this matter in Phase 3.

settlement agreement in which Verizon and ORA's predecessor, the Division of Ratepayer Advocates, eliminated "the need to determine a market-based . . . ROR for [Verizon]."[45] The adopted settlement went on to state:

> If any party to this Settlement Agreement proposes in the future to impose a requirement that [Verizon] return to ratepayers any portion of earnings . . . or the reinstitution of a market-based . . . rate of return, **<u>its shall be assumed that the market-based rate of return under this Settlement Agreement is 10.50%</u>**. (D.93-09-038, 50 CPUC 2d 685, 699. Emphasis added.)

In D.98-10-026, the Commission ordered Verizon to file an annual price-cap advice letter in which Verizon is required to report, among other things, the market-based ROR last found reasonable for Verizon.[46] Verizon has reported a market-based ROR of 10.5% in its price-cap advice letters filed pursuant to D.98-10-026.[47] In light of the previously described Commission precedent, parties are invited to address in Phase 3 whether the Commission should determine the existence and amount of excessive directory earnings in the future using an ROR of 10.5%, 11.5%, or some other ROR.

We agree with ORA and TURN that the imputation of directory earnings is consistent with FCC regulations. The FCC's own rules allow states to impute directory revenues for state ratemaking purposes.[48] Further, the Commission in D.91-07-056 held that the determination of sharable earnings starts with the FCC's Part 32 accounts, less Part 36 (separations) and Part 64 (below-the-line cost

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[45] D.93-09-038, 50 CPUC 2d 685, 698 - 99.

[46] D.98-10-026, Ordering Paragraph 1.c., 82 CPUC 2d 335, 378.

[47] See Resolutions T-16680, issued on August 22, 2002, T-16656, issued on June 27, 2002.

[48] Exhibit 211, para. 7.

allocations), plus or minus any modifications adopted by this Commission.[49] Directory earnings have always been included as one of these modifications.

We decline to adopt at this time ORA's proposal to require Verizon to conduct studies to determine if the services provided by the Directory Affiliate are priced at the lower of cost or market value. The obvious purpose of these studies is to determine if Verizon is in compliance with the Commission's rules for affiliate transactions. As described previously, Verizon's transactions with its Directory Affiliate are largely exempt from those rules. We also believe that the public interest would be better served if ORA routinely monitored and audited Verizon's relationship with its Directory Affiliate rather than relying on studies that are subject to gaming.

B. Electronic Directory Revenues

1. Position of the Parties

ORA recommends that the Commission investigate whether the revenues that Verizon's Directory Affiliate receives from electronic directories should be imputed for ratemaking purposes. ORA believes that its proposal is reasonable in light of the close relationship between electronic directories and Verizon's traditional printed directories. The closeness of the relationship is shown in a recent quarterly report to shareholders wherein Verizon's parent company indicated that its bundling of print and online services is producing higher revenues for the Internet directory service:

> Revenues from SuperPages.com, Verizon's Internet directory service, grew 44.5 percent over second quarter 2000 as Information Services carried out its strategy to bundle print and online services. (Exhibit 106, p. 7)

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[49] D.91-07-056, 41 CPUC 2d 89, 119.

TURN supports ORA's proposal. TURN submits that ORA’s testimony demonstrates that the electronic directory is an extension of the paper one, since both are bundled together as an integrated advertising service. TURN argues that it is reasonable to investigate whether such closely related services should be afforded the same ratemaking treatment.

Verizon's opposes ORA's proposal to investigate whether revenues from electronic directories should be imputed for ratemaking purposes. Verizon represents that it has no interest -- financial, legal, or otherwise -- in any electronic directory. Verizon also represents that it performed no services during the audit period pertaining to electronic directories. Verizon adds that if ORA's proposal is adopted, Verizon earnings would actually decrease during the audit period, not increase, because the Directory Affiliate lost money on its electronic directory business during that period.

2. Discussion

We are persuaded by ORA and TURN that it would be worthwhile to investigate whether revenues from electronic directories should be imputed for ratemaking purposes. ORA has demonstrated that affiliated electronic directories profit from their association with traditional directories, and there is a strong case to be made that ratepayers, not just shareholders, should benefit from this association. We are also concerned that any success enjoyed by electronic directories due to their affiliation with traditional directories might erode Yellow Page revenues and thereby diminish the financial support that Yellow Pages provide to basic telephone service. If this were to occur, then ratepayers would be harmed by the affiliation and should be compensated for the harm.

ORA did not suggest a procedural vehicle for investigating whether revenues from electronic directories should be imputed for ratemaking purposes.

Elsewhere in this decision, we direct ORA to conduct another audit of Verizon. We conclude that this audit would be an appropriate vehicle for gathering information needed to investigate whether revenues from electronic directories should be imputed for ratemaking purposes. To this end, ORA's audit should examine affiliated electronic publishing activities for the purpose of identifying and, to the extent possible, quantifying (1) the benefits that traditional directories provide to electronic directories, and (2) any actual or potential loss of revenues incurred by traditional directories due to their affiliation with electronic directories. As described later in this decision, ORA should submit its audit findings in the next triennial review of NRF.

C. Changes to Affiliate Rules

1. Position of the Parties

a. Verizon

Verizon proposes that the Commission make three revisions to its rules governing affiliate transactions. First, Verizon asks the Commission to modify its rules so that Verizon does not have to perform market studies to determine if the services it purchases from an affiliate that meets the FCC's definition of a "service company" are priced at the lower of FDC or FMV. Unlike the Commission, the FCC permits affiliated "service companies" to price all services at FDC.[50] Verizon states that the FCC recognized that requiring utilities to perform market studies for transactions with affiliated service companies would increase costs for ratepayers while providing limited benefit:

> We find that when an affiliate is established to provide services solely to the carrier's corporate family in an effort to take advantage of economies of scale and scope, the benefits of such economies of scale and scope are . . . ultimately

[50] 47 C.F.R. 32.27(c).

> transferred to ratepayers through transactions with the carrier for such services valued at fully distributed costs. Requiring carriers to perform fair market valuations for such transactions would increase the cost to ratepayers while providing limited benefit. (FCC Order 96-490, para. 148.)

Verizon represents that its proposal is similar to a rule that the Commission adopted for Pacific Bell in D.99-03-057. There, the Commission approved Pacific Bell's request to use FDC for pricing services provided by centralized support organizations and SBC Communications Inc.

Verizon states that its proposal is directly applicable to certain unresolved issues raised in ORA's audit report. In particular, the audit report recommended that Verizon prepare market studies for services provided by Verizon's Data Services Affiliate and Long-Distance Affiliate in order to demonstrate that the prices charged by these Affiliates are the lower of FDC or FMV.[51] Verizon states that adoption of its proposal would obviate ORA's recommendation.

Verizon's second proposed revision to the Commission's rules is to adopt the FCC's "prevailing-price rule." Under the FCC's rule, if more than 25% of a non-tariffed product or service is sold to unaffiliated customers, then the telephone company and its affiliate may sell the product or service to one another at the prevailing price. The prevailing price is the price at which the product or service is sold to the general public. Verizon states that the presence of significant sales to third parties alleviates the need for a study to demonstrate market price, as the prevailing price is the market price.

Verizon's third proposed revision to the Commission's rules is to increase the threshold for when a market study is required. The Commission's rules

[51] Joint Exhibit, Issues 18, 19, 43, and 44. Verizon agreed to make financial adjustments for its failure to conduct market studies during the audit period. What the parties dispute is whether Verizon should perform market studies on a prospective basis.

require Verizon to perform a market study for any transaction involving assets, goods, or services that are valued at more than $100,000.[52] The FCC, in contrast, does not require market studies unless the annual sales of an asset or service are valued at more than $500,000 per year.[53] Verizon maintains that adopting the FCC's threshold of $500,000 would reflect the FCC's determination that below this threshold the administrative cost and effort of conducting market studies outweighs the regulatory benefits.[54]

b. ORA

With one exception, ORA opposes Verizon's proposals to revise the Commission's rules for affiliate transactions. ORA states that Verizon's proposals would be a major departure from the Commission's current rules, and ORA is concerned that neither it nor the Commission have had an opportunity to examine the proposals. In order to provide an opportunity to properly consider the merits and ramifications of Verizon's proposals, ORA recommends that Verizon file a formal application as Pacific is required to do by D.99-03-057.[55]

ORA does not oppose Verizon's proposal to raise the threshold for a market study from $100,000 to $500,000 for the sale of assets. ORA objects, however, to raising the threshold for services. ORA states that while $500,000 worth of services is not a substantial sum to Verizon, it is a large amount to some of Verizon's affiliates. ORA believes that in order to ensure that the unregulated affiliates do not have a competitive advantage, it is necessary to retain the $100,000 threshold for services exchanged between Verizon and its affiliates.

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[52] Resolution T-15950, issued on December 9, 1996.

[53] For Services: FCC Order 00-78. For Assets: FCC Order 01-305.

[54] FCC Order 00-78, para. 19.

[55] D.99-03-057, *mimeo.*, p. 5.

c. TURN

TURN opposes Verizon's proposals to revise the Commission's rules for affiliate transactions. TURN asserts that the FCC's regulatory concerns in this area are narrower than the Commission's. Thus, what might be adequate and efficient for the FCC's purposes might not be so for the Commission's.

TURN states that Verizon's reliance on D. 99-03-057 as justification for its proposal is misplaced. That decision focused almost exclusively on Intellectual Property and Proprietary Assets (IPPA). While the decision appears to have approved use of FDC for service companies, it did so without discussion, evidentiary hearings, or a clear ordering paragraph to that effect. TURN opines that a five-page decision with 4 findings of fact, 5 conclusions of law (COLs), and 12 ordering paragraphs—all related to IPPA—is slim support for a major change to Commission's affiliate rules.

TURN states that ORA's audit found that affiliated service companies overcharged Verizon by millions of dollars during the audit period. The audit also showed that Verizon unilaterally chose to violate Commission rules and instead followed FCC rules.[56] In light of these audit findings, TURN believes the Commission should be cautious in changing its rules for affiliate transactions.

2. Discussion

We decline to adopt at this time Verizon's proposed changes to our rules governing affiliate transactions. Verizon has not demonstrated any flaws in our rules that need to be remedied at this time. Moreover, we do not wish to revise our rules through piecemeal changes that affect only one utility as Verizon proposes to do here. Rather, it is our general policy to apply a uniform set of

[56] Exhibit 103, pp. 1-19, 1-20, 10-5, and 10-9.

rules to all utilities in order to promote administrative efficiency and to treat all utilities equally and fairly.[57]

Consistent with our decision today to retain our current rules for affiliate transactions, Verizon shall comply with the existing requirement to conduct market studies for all affiliate transactions valued at more than $100,000.[58]

V. ORA's Proposed Rate Reduction

1. Position of the Parties

a. ORA

ORA recommends that the Commission reduce Verizon's intrastate rates by a total of $104 million over a three-year period.[59] The proposed rate reduction is equal to the amount of misallocated costs and revenues between Verizon and its affiliates that ORA found during its audit.

ORA offers several reasons why it is reasonable to reduce Verizon's rates by $104 million. First, ORA asserts that the misallocated amounts placed ratepayers at risk for paying higher rates. ORA argues that its proposed rate reduction would compensate ratepayers for the risk they bore.

Second, ORA claims the misallocations caused material misstatements in the financial reports that Verizon submitted to the Commission. ORA believes there is a strong possibility that the Commission would not have suspended the sharing mechanism and the annual productivity adjustment in D.98-10-026 if the

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[57] D.97-04-041, 71 CPUC 2d 629, 637; OIR.92-08-008, 1992 Cal. PUC LEXIS 576, *2, *9 – *13.

[58] The Joint Exhibit, Attachment B, contains Verizon's affiliate transactions pricing guidelines. The guidelines reflect the FCC's rules, including those that are not adopted by today's decision. The guidelines at page 3 recognize, however, that the FCC and the states may have different requirements pertaining to affiliate transactions. Today's decision does not adopt or otherwise endorse those parts of the guidelines that do not comply with Commission requirements pertaining to affiliate transactions.

[59] Exhibit 100, pp. 12 – 13; revised Exhibit 212, W / P 1.

Commission had known of ORA's audit findings. ORA states that its proposed rate reduction provides partial compensation to ratepayers for billions of dollars they lost when the Commission suspended the sharing mechanism and productivity adjustment based on faulty information supplied by Verizon.

Third, ORA avers that ratepayers would have benefited from ORA's proposed ratemaking adjustment under cost-of-service ratemaking that was in effect prior to NRF. ORA declares that ratepayers should be no worse off under NRF than under traditional cost-of-service regulation. In ORA's view, simply dismissing the audit report’s financial adjustments because there is no longer cost-of-service ratemaking fails to make ratepayers whole.

Finally, ORA asserts that the misallocations were caused by Verizon's repeated failure to adhere to the Commission's rules, resulting in ratepayers subsidizing unregulated activities. ORA claims that its proposed rate reduction is necessary to hold Verizon accountable for its failure to comply with the Commission's rules. ORA also contends that unless Verizon is held accountable, Verizon will have little incentive to fulfill its obligations under the Joint Exhibit.

ORA acknowledges that correcting the misallocations would not increase Verizon's earnings above the NRF sharing threshold that was in effect during 1996 through 1998. Consequently, Verizon's ratepayers would not benefit from the correction of the misallocations via the NRF earnings-sharing mechanism. ORA believes this would be an unjust result, as Verizon should not profit from having mislead the Commission about its cost allocations.

ORA opines that its proposed rate reduction is consistent with NRF. This is because the Commission in D.91-07-056 explicitly reserved its right to fashion remedies under NRF.[60] In addition, ORA believes the Commission would not have ordered NRF audits if it did not intend to make audits an effective means of ensuring Verizon's compliance with the Commission's rules and policies. ORA argues that if the Commission does not reflect the audit adjustments in rates, audits will fail to have their intended effect of helping to ensure Verizon's compliance with the Commission's rules and policies.

ORA represents that its proposed rate reduction is not reflected in Verizon's initial rates under NRF that went into effect on January 1, 1990. ORA maintains that Verizon's initial rates reflected only those ratemaking adjustments that were in effect at that time, and could not have conceivably included all future ratemaking adjustments.

ORA asserts that the Commission has previously bypassed the NRF sharing mechanism in order to ensure that ratepayers receive the financial benefit of ratemaking adjustments. Specifically, in D.97-03-067 the Commission ordered Pacific to refund $248 million to ratepayers over five years. Pacific implemented the refund as a Z-factor. ORA states that there is no discussion in D.97-03-067 whether the refund met the nine Z-factor criteria, which demonstrates that the Z-factor criteria are not applicable to ratemaking adjustments ordered by the Commission.

ORA argues that D.01-06-077 does not apply to ORA's proposed rate reduction. In that decision, the Commission used the NRF earnings-sharing mechanism to flow through ratemaking adjustments stemming from an ORA audit of Roseville Telephone Company (Roseville). ORA states that unlike the case with Roseville, Verizon's sharing mechanism will not result in any of ORA's audit adjustments reaching ratepayers. ORA also believes the Commission is not

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60 41 CPUC 2d 89, 119 and 131.

bound by the Roseville decision because the Commission in D.91-07-056 reserved its right to fashion remedies under NRF on a case-by-case basis.

b. Pacific Bell

Pacific Bell opposes ORA's ratemaking adjustment. Pacific states that in order for ORA's proposed remedy to be considered valid, it must be reasonably related to actual harm suffered or found. ORA's proposed remedy fails this test, according to Pacific, because not one dollar of the purported misallocations was ever incorporated into Verizon's rates.

Pacific states that there is no place for ORA's proposal under NRF where the Commission has regulated prices by the price-cap formula. Pacific posits that the misallocated amounts at issue were not used to set rates, since Verizon's rates before, during, and after the audit period were regulated without respect to the accounting costs at dispute in the audit.

Pacific contends that the only means by which ORA's audit adjustment could reach ratepayers would be through the NRF sharing mechanism. Pacific states that even if all of ORA's alleged audit adjustments are correct, Verizon's ROR did not exceed the sharing threshold in any year. Accordingly, Verizon has no obligation to share any amount with ratepayers.

c. TURN

TURN supports ORA's proposed rate reduction. TURN states that the Commission has long relied on statutorily mandated audits as an essential part of the Commission's regulatory oversight.[61] In TURN's view, there is little point to audits without the opportunity to implement ratemaking adjustments.

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[61] D.89-10-031, 33 CPUC 2d 43, 185, and 196; D.94-06-011, 55 CPUC 2d 1, 24 - 25; D.96-05-036, 66 CPUC 2d 274, 278, and FOF 10; and D.98-10-026, 1998 Cal. PUC LEXIS 669 at *69 - *72 and FOF 42.

TURN opines that ORA's proposed rate reduction is consistent with NRF. This is because when the Commission established NRF in D.89-10-031, it anticipated that there might be ratemaking adjustments arising from management misconduct.[62] Subsequently, in D.91-07-056 the Commission emphasized the need under NRF for "flexibility to fashion remedies as may be appropriate to the given problem."[63]

TURN argues that ORA's proposed rate reduction would provide a powerful incentive for utilities to comply with the Commission's accounting rules. Those rules serve two of the eight regulatory goals specified in the original NRF decision: (1) avoidance of cross subsidies and anticompetitive behavior, and (2) low cost, efficient regulation. TURN states that in supporting those goals, ORA's proposal maintains the integrity of NRF.

TURN urges the Commission to avoid the conclusion that the earnings-sharing mechanism is the only means for ORA's audit adjustments to affect rates under NRF. TURN states that this would be an especially troubling standard in cases where an audit adjustment does not trigger sharing or where sharing has been suspended or eliminated. Under such circumstances, there could never be audit-based adjustments, regardless of the egregiousness of the utility's practices that led to the audit adjustment.

TURN argues that ORA's proposed rate reduction is consistent with D.01-06-077. TURN states that the Commission made it very clear in that decision that its concerns arising from ORA's audit of Roseville were not limited to the impact the audit adjustments would have on shareable earnings:

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[62] D. 89-10-031, 33 CPUC 2d 43, 186.

[63] 41 CPUC 2d 89, 119.

> The audit results show that [Roseville] has effectively cross-subsidized its affiliates at the expense of [its] reported earnings. . . Such cross-subsidization directly contravenes the pro-competitive policies of this Commission as it unfairly disadvantages the firms which must compete against [Roseville's] affiliates and lack the funding source of monopoly or near-monopoly services. The foregoing further demonstrates that cross-subsidization by [Roseville] depressed [Roseville's] earnings so significantly as to prevent sharing that otherwise would have occurred absent the cross-subsidization. By applying the sharing mechanism to [Roseville's] corrected earnings for 1998 and 1999, shareholders will be denied a measure of the benefits from the improper cross-subsidization of [Roseville's] affiliates. In addition, sharing will allow ratepayers to gain some of the benefits from costs for [Roseville]that should have been lower had they been properly recorded and allocated. (D.01-06-077, *mimeo.*, pp. 61 - 62.)

TURN observes that in the Roseville proceeding, ORA's audit adjustments triggered additional sharing in two of the three years covered by the Roseville audit. In contrast, the Verizon audit adjustments trigger no additional sharing. So, where the sharing mechanism served in Roseville's case to "limit the benefits that shareholders may reap from improper cost shifting,"[64] it fails to serve that purpose for Verizon. Thus, in order to send the same type of message to the utility and its shareholders as the Commission described in the Roseville decision, it will need to rely on some other mechanism.[65] TURN believes that ORA's proposed rate reduction is one such mechanism.

[64] D.01-06-077, FOF 7.

[65] The Commission stated in D.01-06-077, Fn. 6: "[T]he Commission may apply other sanctions, including penalties, if it finds that [Roseville] or its affiliates are engaging in practices that violate any statutes or any rules, orders, or other requirements of this Commission."

d. Verizon

Verizon opposes ORA's proposed rate reduction.[66] Verizon states that the fundamental flaw in ORA’s proposal is that it bears no relationship to the alleged problems that it seeks to remedy. Verizon argues that such a connection is essential because the purpose of ORA’s proposal is to compensate ratepayers for the harm that Verizon allegedly inflicted upon them. Absent any connection between the alleged harm and the compensation, ORA’s proposal is improper and unreasonable.

Verizon contends that the two largest components of ORA's proposed rate reduction highlight the lack of connection between ORA's audit findings and its proposed remedy. The largest component is a rate reduction of $62 million for excessive directory earnings. Verizon states that the rate reduction is inappropriate under NRF, since rates are independent of costs. In addition, a rate reduction for excessive directory earnings was built into Verizon's initial rates under NRF. As a result, Verizon's rates already reflect a ratemaking adjustment for excessive directory earnings. Furthermore, the Commission in D.91-07-056 terminated further ratemaking adjustments for excessive directory earnings. Thus, Commission precedent explicitly prohibits ORA's proposed rate reduction for excessive directory earnings.

The second largest component of ORA's proposal is a $32 million rate reduction for Verizon's inability to provide support for the “I-factor“ that was used to allocate certain types of costs between Verizon and its affiliates. Verizon represents that it lost the supporting documentation during an office move. Verizon states that while it could not produce the documentation, the record

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[66] Verizon agrees to restate its historical financial reports to reflect those ORA audit adjustments adopted by the Commission, and will do so at the conclusion of Phase 1.

indicates that such documentation did exist. The record further indicates that the I-factor was replaced by the S-factor -- the one preferred by ORA -- prior to the release of the audit report. Verizon asserts that the adjustment of $32 million, which represents the difference between the S-factor and I-factor, has no foundation. There is no finding in the ORA's audit report that the I-factor was improper, that losing the documentation was anything other than inadvertent, or that ratepayers were harmed. In Verizon's opinion, the only proper adjustment is to restate historical earnings, which Verizon has agreed to do.

Verizon states that ORA's proposed rate reduction is predicated on the allegation of ratepayer harm. Verizon contends there was no harm, since ORA admits that no rates were affected by the misallocations.[67] Nor was there any possibility of harm, according to Verizon, since the Commission sets rates based on models of forward-looking costs that, by their very nature, do not reflect historical accounting costs like those at issue in ORA's audit report.

Verizon disputes ORA's contention that it is necessary to reduce Verizon's rates in order to ensure Verizon's compliance with the Commission's rules. Verizon asserts that there is no need for a financial penalty to ensure compliance, since the record demonstrates that Verizon takes compliance very seriously. For example, ORA acknowledged that Verizon cooperated with ORA during the audit process.[68] After the audit report was released, Verizon and ORA worked collaboratively to resolve the issues in the audit report. Almost all issues were resolved as demonstrated in the Joint Exhibit. Any unresolved issues were due to good-faith disagreements that are being litigated here. All this was done without any threat of financial penalty.

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[67] 1 Tr. 48:19-26.

[68] 1 Tr. 9:13-19.

Verizon believes that the Commission's treatment of ORA's audit results in the Roseville NRF proceeding is instructive. There, the Commission adjusted Roseville's earnings in response to ORA's audit. Shareable earnings, if any, were revised to reflect the audit adjustments, but no dollar-for-dollar rate reduction was imposed for the year in which sharing was not triggered, and no other ratemaking adjustments were proposed by ORA or adopted by the Commission to supplement the sharing mechanism. Verizon contends that the same result should hold true here. If adopted audit adjustments lead to sharing, then sharing should occur. If not, then no sharing should occur. This result would treat Verizon's ratepayers the same as the Commission treated Roseville's.

2. Discussion

ORA argues that the Commission should adopt its proposed rate reduction because of the harm suffered by Verizon's ratepayers. ORA admits, however, that no rates were affected by the misallocated costs and revenues that comprise its proposed rate reduction.[69] Rather, the harm alleged by ORA is the risk that rates could have been affected by the misallocated amounts.[70] As a general principle, we agree with ORA that if ratepayers were placed at significant risk of paying higher rates because of the misallocated amounts, this would constitute the type of management misconduct contemplated by D.89-10-031 and D.91-07-056 that would warrant a rate reduction.[71] Therefore, in deciding whether to adopt ORA's proposed rate reduction, a key issue is whether the misallocated amounts posed a significant risk of higher rates.

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[69] Sanchez, 1 Tr. 73:14-28 and 74:1-4.

[70] 1 Tr. 48:23 - 49:8 and ORA Opening Brief at p. 27.

[71] D.89-10-031, 33 CPUC 2d 43, 186; D.91-07-056, 41 CPUC 2d 89, 152.

Under the NRF structure that was in place during the audit period of 1996 – 1998, there were few opportunities for the misallocated amounts to affect rates. One opportunity was the earnings-sharing mechanism. Under that mechanism, Verizon retained all of its earnings up to the ceiling ROR of 15.5%, and any earnings above the ceiling ROR were refunded to ratepayers.[72] The following table shows the impact on Verizon's ROR from (1) the misallocated amounts identified in ORA's audit report, and (2) excessive directory earnings that were improperly withheld from Verizon as described earlier in this decision:

	1996	**1997**	**1998**
Verizon's ROR Reported to the Commission [1]	11.17%	12.10%	12.72%
Effect of the Misallocated Amounts on Verizon's ROR [1, 2]	0.27%	0.15%	0.20%
Effect of Excessive Directory Earnings on Verizon's ROR [3]	0.40%	0.11%	0.72%
Revised ROR	11.84%	12.36%	13.64%
Sharing Threshold	15.50%	15.50%	15.50%
ROR in Excess of Sharing Threshold	0.00%	0.00%	0.00%

[1] **Source**: Revised Exhibit 212, W/P 5.

[2] Does not include ORA's audit adjustment for excessive directory earnings.

[3] **Source**: Revised Exhibit 212, W/Ps 1 and 5.

The above table shows that the misallocated amounts, when combined with the excessive directory earnings that were improperly excluded from the determination of Verizon’s sharable earnings (referred to collectively hereafter as “the misallocations“), would not have increased Verizon's ROR above the sharing threshold of 15.5% that was in effect during 1996 - 1998. This does not

[72] D.93-09-038, 50 CPUC 2d 684, 689.

mean, however, that there was no risk of the misallocations affecting rates through the sharing mechanism. Verizon's earnings are affected by many variables. Hence, there was always the possibility that Verizon's earnings could have exceeded the sharing threshold during the audit period depending on how events unfolded. However, given that Verizon's earnings, when combined with the misallocated amounts, were well below the sharing threshold of 15.5%, we conclude that there was little risk of the misallocated amounts affecting rates through the sharing mechanism during the audit period.[73]

Another opportunity for the misallocations to have affected rates under NRF is if the misallocations were incorporated into the "cost studies" that are used to set rates. Because there is no evidence in this proceeding that the misallocations affected past or current rates, the misallocations could affect rates only on a prospective basis. This could occur in either of two ways. First, Verizon has submitted cost studies pursuant to D.96-08-021,[74] which remain pending before the Commission.[75] The Commission intends to use these cost studies to set prices for (2) Unbundled Network Elements (UNEs),[76] and (2) price floors for local exchange services that were transferred to Category II pursuant to D.96-03-020.[77] There is no evidence in this proceeding that the misallocations are

[73] There was no risk that the misallocations could have affected sharing in 1999 and beyond, since the Commission suspended the sharing mechanism in D.98-10-026.

[74] D.98-02-106, 78 CPUC 2d 563, 629; D.96-08-021, 67 CPUC 2d 221, 269.

[75] D.00-03-025, 2000 Cal. PUC LEXIS 142, *22; D.99-12-018, 1999 Cal. PUC LEXIS 839, *16.

[76] D.96-08-021, 67 CPUC 2d 221, 269. UNEs were previously referred to as Basic Network Functions. (D.98-12-079, 1998 Cal. PUC LEXIS 975, *11)

[77] D.96-03-020 (65 CPUC 2d 156, 191, 212), as modified by D.99-12-018 (1999 Cal. PUC LEXIS 838, *15, *19) and D.00-03-025 (2000 Cal. PUC LEXIS 142, *21 - *22).

reflected in these cost studies.[78] However, we cannot rule out the possibility, as the Commission has yet to review these studies in a formal proceeding. We conclude, therefore, that it is remotely possible that the misallocations are embedded in these cost studies and could have affected rates had the misallocations not come to light in this proceeding.[79]

The second way the misallocations could have affected rates via cost studies is if Verizon were to include the misallocations in studies submitted some time in the future.[80] It is pure speculation whether Verizon would have submitted any such studies. Nevertheless, we cannot rule out the possibility. We conclude, therefore, that there was a remote possibility that ratepayers could have been harmed by the inclusion of the misallocations in future cost studies had the misallocations not come to light in this proceeding.

Another opportunity for the misallocations to have affected rates under NRF was through the floor mechanism. This mechanism allowed Verizon to petition for reconsideration of the adopted inflation and productivity factors if its ROR fell below 7.75% for two years in a row.[81] Given that Verizon's ROR never approached the floor ROR during the period of 1996 - 1998,[82] we conclude that

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[78] In Applications (A.) 01-02-012 and A.01-12-040, which are currently pending before the Commission, Verizon seeks authority to (i) move inside wire maintenance, national directory assistance, and operator-assisted calls from Category II to Category III; and (ii) increase rates for these services. There is no evidence in this proceeding that the misallocations have been used by Verizon to justify higher rates for these services.

[79] ORA has had access to Verizon's cost studies for several years. We infer from ORA's silence that it did not check the cost studies to determine if the misallocations are incorporated into the studies, or that it did check and found no problems.

[80] Verizon can submit cost studies in the future to adjust the price for a single service if, for example, it proposes to move a service between categories.

[81] D.93-09-039, 50 CPUC 2d 684, 689, 695, and 699.

[82] Appendix A of this decision shows that Verizon's RORs during 1996 – 1998 ranged from 11.84% to 13.64%.

there was little risk of Verizon filing an application under the floor mechanism that included the misallocations.

Although the Commission suspended the floor mechanism in D.98-10-026,[83] Verizon could still file an application for a general rate increase if there were a dramatic fall in its ROR.[84] Given the strong RORs that Verizon has experienced since the suspension of the floor mechanism,[85] we conclude that there was little risk of Verizon filing an application for a general rate increase, either in the past or the foreseeable future, that included the misallocations. Moreover, even if Verizon did file such an application, it is quite possible that the application would be denied for the reasons stated in D.98-10-026:

> [I]f rates of return become unreasonably low, Pacific and / or [Verizon] might be obligated to consider applying for rate relief. We caution that they should do this with great hesitation, however. They should be very hesitant because, in support of the elimination of sharing at high rates of return, they argue that the floor should be eliminated, and shareholders should take the full risk of variations in rate of return. We agree with, and adopt, this rationale in our suspension of sharing. Thus, we do not expect to see such application even if rates of return fall dramatically. If one is filed, we will look on such application with great skepticism given the fundamental reasons for adopting NRF, including the changes we authorize today.
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> If such application is filed, applicant must clearly and convincingly address why the balancing of risks and rewards (by suspending sharing and thereby removing both the ceiling and the floor rates of return) should be disturbed by a rate increase to the benefit of the utility and its shareholders. Moreover, given the suspension of sharing, applicant will be

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83 D.98-10-026, *mimeo.*, p. 92.

84 D.98-10-026, *mimeo.*, pp. 49 – 50.

85 Appendix A shows that Verizon's RORs during 1999 – 2001 ranged from 14.90% to 18.67%.

> held to a more demanding test than the earnings floor test in place before the suspension of sharing. (D.98-10-026, 82 CPUC 2d 335, 359 – 360.)

The final opportunity for the misallocations to have affected rates under NRF is if the Commission had known of the misallocations when it suspended the earnings-sharing mechanism and the productivity factor in D.98-10-026. Based upon our review of D.98-10-026, it is clear that the Commission's decision to suspend the sharing mechanism and productivity factor relied, in part, on Verizon's reported earnings. For example, FOF 9 states that Verizon's earnings for 1996 and 1997 "do not show that the elimination of the [productivity factor] allowed Pacific and [Verizon] to accumulate financial resources to gain [an] unfair competitive advantage[.]" FOF 26 states that there had been no sharing for Verizon since 1993. As shown in Appendix A of this decision, we now know that Verizon's RORs in 1996 and 1997 were actually 11.84% and 12.36%, respectively, rather than the reported 11.17% and 12.10%, differences of 67 basis points and 26 basis points. These differences, while significant and troubling, would not have generated sharable earnings for Verizon, which appears to have been the primary reason for the Commission's consideration of Verizon's reported earnings in D.98-10-026.

Nor does the remainder of D.98-10-026 indicate that earnings for Verizon in the range of 11.84% to 12.36% would have altered the Commission's decision to suspend the sharing mechanism and productivity factor. FOF 6 summarizes the Commission's reasons for suspending the productivity factor, none of which relate to the level of Verizon's earnings.[86] Likewise, FOF 32 summarizes many of

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[86] FOF 6 states: "Events since 1995, such as the following, demonstrate that significant market changes continue to occur: facilities-based competition in the local exchange market authorized in late 1995; resale competition in the local exchange market authorized in early

Footnote continued on next page.

the Commission's reasons for suspending sharing.[87] None of these reasons relate to the level of Verizon's reported earnings.

Based on our reading of D.98-10-026, we find that the effect of the misallocations on Verizon's reported earnings was not sufficiently large to have changed the Commission's decision in D.98-10-026 to suspend sharing and the productivity factor. However, our finding does not excuse the misallocations or condone Verizon's apparent violations of our rules. Our ability to make sound decisions depends on utilities' providing accurate information. It is especially important to have accurate information in our triennial reviews of NRF about the impacts of the current NRF rules on the utilities and their customers, because those impacts may affect the rules we adopt for the future. The inaccurate information that Verizon provided about its earnings has caused us to engage in an unnecessary – and frankly uncomfortable – analysis of whether D.98-10-026 might have been different if Verizon had provided accurate earnings reports. Verizon's conduct, whether inadvertent or otherwise, has harmed our regulatory process and signals a need to revise NRF in ways that would prevent and deter utilities from submitting inaccurate information the future.

ORA asserts that ratepayers were exposed to the risk of cross-subsidizing unregulated activities. In order for cross subsidies to harm ratepayers directly,

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1996; Telecommunications Act of 1996 signed into law (designed to open all telecommunications markets to competition, including local exchange services); over 150 competitive local carriers (CLCs) authorized to operate in California as of May 1998; and over 100 Commission-authorized interconnection agreements approved between Pacific, [Verizon] and CLCs as of August 1998."

[87] FOF 32 states: "Sharing must be suspended based on changes in the market, the importance of providing an undistorted basis for financial analysis, the need to provide correct economic incentives, the need to protect ratepayers from sharing in risky or bad operating and investment decisions, and the need to place the full risk of those decisions on shareholders."

the subsidies must be reflected in rates.[88] That did not occur here, and there was little risk of that occurring for the previously stated reasons. Nevertheless, ORA's audit report establishes a strong case that Verizon did, in fact, subsidize unregulated activities.[89] These subsidies might have harmed ratepayers indirectly in a variety of ways. For example, ratepayers could have been harmed to the extent the subsidies (1) reduced the resources that otherwise would have been used to support regulated utility services, or (2) undermined competition in the markets for the goods and services provided by the Verizon affiliates that benefited from the subsidies. However, there is no evidence in the record that any indirect harm occurred.

For the preceding reasons, we conclude that the misallocations caused no direct or indirect harm to ratepayers and never posed more than a small risk of harm to ratepayers.[90] In the absence of actual harm or significant risk of harm, we conclude that it would be unreasonable to adopt ORA's proposal to reduce Verizon's rates by $104 million.[91]

Our decision today regarding ORA's proposed rate reduction is consistent with D.01-06-077. In that decision, the Commission reduced Roseville's rates to reflect the misallocated costs found by an ORA audit. However, not all the misallocated costs were reflected in rates. Rather, only 50% of those misallocated

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88 D.89-10-031, 33 CPUC 2d 41, 105, 113 - 114, 144, 151, 218, and 228; D.91-07-056, 41 CPUC 2d 89, 113, and 114.

89 Joint Exhibit, Issues 13, 16, 25, 33, 36, 44, and 85.

90 ORA's proposed rate reduction of $104 million includes $62 million for excess directory earnings. Because Verizon's initial rates under NRF purportedly include a ratemaking adjustment for excessive directory earnings, it appears that ORA's proposed rate reduction might, to some extent, be double counting excessive directory earnings.

91 Today's decision does not prejudge ORA's proposal in Phase 2 to reduce Pacific's rates by the amount of the audit adjustments identified in TD's audit report.

costs above the NRF sharing threshold were refunded to ratepayers.[92] In fact, none of the misallocated costs for one year were reflected in rates, since Roseville's earnings for that year did not exceed the sharing threshold. As a result, only a fraction of the misallocated costs at issue in the Roseville proceeding were refunded to ratepayers.[93] The Commission's treatment of ORA's audit adjustments was consistent with NRF as then constituted because it adjusted only that part of NRF that was affected by the audit – the sharable earnings. Here, Verizon's earnings never exceed the sharing threshold, even when the misallocations are taken into account. ORA's proposed rate reduction, which would bypass the NRF sharing mechanism and reduce Verizon's rates by 100% of the misallocated amounts, constitutes a significant departure from the Commission's approach in the Roseville proceeding.

ORA contends that relying on the sharing mechanism unfairly insulates Verizon from the financial impact of ORA's audit adjustments. We disagree. If Verizon had correctly accounted for its costs and revenues to begin with, the misallocations would have been reflected in the sharing mechanism, although no sharing would have occurred by doing so. The fact that misallocations occurred does not mean that the NRF rules that were in existence when the misallocations occurred should be ignored once the misallocations are discovered. The appropriate remedy under the applicable NRF rules is to incorporate the misallocations into the sharing mechanism and, if warranted, impose a monetary penalty pursuant to Pub. Util. Code § 2107.

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[92] Under Roseville's sharing mechanism, 50% of Roseville's earnings within a specified range were refunded to ratepayers. Under Verizon's sharing mechanism, Verizon retained all earnings up to an ROR of 15.5% and refunded to ratepayers all earnings above 15.5%.

[93] D.01-06-077, *mimeo.*, p. 57.

ORA claims that we must reduce Verizon's rates so that ratepayers are no worse off under NRF than under traditional ratemaking. We agree that the misallocations should not be reflected in rates under any regulatory scheme. For the previously stated reasons, ORA has not shown that the misallocations affected prior or existing rates, and today's decision ensures that future rates will not be affected. As a result, ratepayers are no worse off with respect to the misallocations under NRF than under traditional ratemaking

ORA believes that if we do not reduce Verizon's rates by $104 million, Verizon will have no incentive to fulfill its obligations under the Joint Exhibit adopted by today's decision. We note that the Joint Exhibit, because it is part of today's decision, has the force and effect of law. Therefore, Verizon will be subject to monetary penalties and other sanctions if it does not fulfill its obligations under the Joint Exhibit. We believe that the threat of sanctions is adequate incentive for Verizon to comply with the Joint Exhibit.

ORA and TURN argue that the Commission in D.91-07-056 explicitly reserved its right under NRF to fashion remedies. They further argue that, because audits are required under NRF, it is permissible to reduce rates under NRF based on audit adjustments. We agree that the Commission has discretion to order rate reductions. But the fact that the Commission has discretion does not address whether ORA's proposed rate reduction is an appropriate remedy. As the preceding discussion shows, we are not convinced that the facts presented in Phase 1 warrant a rate reduction under the applicable NRF rules. We recognize, however, that we are confronted with an issue of first impression under NRF – whether accounting irregularities that artificially depress earnings should prompt rate reductions. Heretofore, there has not been a NRF rule that required utilities to reduce rates if they provided inaccurate information about their earnings or other matters. Below, we invite proposals in Phase 3 of this proceeding for revisions to NRF that would provide additional incentives for utilities to provide accurate information to the Commission.

TURN claims that rejection of ORA's proposed rate reduction would render audits meaningless. ORA shares this view. We believe that ORA and TURN take too narrow a view of the purpose and function of audits and the benefits they provide to ratepayers. To the extent an audit identifies areas that should be corrected, it can have positive effects. ORA's audit found significant problems that Verizon has agreed to correct. Likewise, in reviewing audits, the Commission may impose a variety of non-ratemaking remedies, such as directing the utility to revise its practices, imposing monitoring requirements, and so on. The Joint Exhibit adopted by today's decision does exactly that. In addition, the information provided by audits may be used to support changes or reforms to NRF, or in monitoring the utility's results of operations. We anticipate that the information provided by ORA's audit will prove useful in Phase 3 of this proceeding when we consider whether and how to revise NRF. In sum, an audit does not have to result in a rate reduction in order to be considered meaningful.

Finally, ORA argues that we must reduce Verizon's rates in order to hold Verizon accountable for its failure to comply with the Commission's rules. The record of this proceeding establishes a strong case that Verizon did not account for affiliate transactions and excessive directory earnings in accordance with the Commission's rules, causing Verizon to record $199 million in higher costs and lower revenues during the period of 1996 through 2001.[94] Although there is no evidence in this proceeding that ratepayers were directly harmed by the accounting irregularities, we are deeply troubled by the magnitude of the

[94] Appendix B of this decision provides a summary of the costs and revenues that were not accounted for in accordance with the Commission's rules.

accounting adjustments. Our ability to make informed decisions affecting millions of Californians is jeopardized when Verizon fails to provide accurate information because of accounting irregularities. The importance we place on accurate and reliable information is underscored by the fact that utilities are subject to severe fines and penalties if they submit false information.[95] Furthermore, even though there was only a small risk that ratepayers could have been harmed by the misallocations, the harm could have been significant had the risk come to pass. We agree with TURN's comments on the Draft Decision that it is precisely because the misallocations placed ratepayers at risk of harm that we must take steps to prevent such misallocations from reoccurring.[96]

We invite parties to present recommendations in Phase 3 for revising NRF in ways that, without resorting to our authority to impose penalties, would deter NRF utilities from submitting inaccurate information in the future. We are particularly interested in proposals that would require rate adjustments, such as ORA has advocated here, when it has been determined that utilities have under-reported their earnings. More generally, we solicit recommendations regarding NRF revisions that would provide additional incentives for utilities to ensure that the information they supply to the Commission for monitoring and other purposes is accurate at the time it is filed.

VI. Future Audits

1. Position of the Parties

ORA recommends that all future triennial reviews include an audit and that the Commission make ORA responsible for conducting these audits.

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95 D.98-10-026, *mimeo.*, p. 45.

96 TURN's opening comments on the Draft Decision, p. 2.

TURN states that all previous NRF decisions recognize that audits are integral to NRF and critical to the Commission’s monitoring and enforcement activities. TURN adds that audits provide an incentive for utilities to comply with the Commission's rules, and give the Commission vital feedback on NRF and its impact on ratepayers.

Verizon states that ORA's audit demonstrates that audits can be expensive and resource-intensive. Verizon suggests that the Commission conduct focused audits, in conjunction with the NRF monitoring program, to accomplish its regulatory goals in a cost-effective manner.

2. Discussion

Audits are an essential part of NRF. They provide a means for the Commission to monitor utility financial performance, to determine if utilities are complying with Commission rules and statutory requirements, and to assess whether the Commission's goals for NRF are being met. ORA's audit shows just how valuable audits can be. Even though ORA's audit focused primarily on affiliate transactions and unregulated activities, which comprise just a small part of Verizon's revenues, expenses, assets, and liabilities, the audit found over $100 million in misallocated costs and revenues as well as instances where Verizon apparently failed to comply with the Commission's rules.

Although NRF has been in effect for more than 12 years, there has yet to be a comprehensive audit of Verizon under NRF. Given the many problems found by ORA's relatively narrow audit, it is clear in retrospect that comprehensive audits should have been conducted routinely. But even if no problems had been found, it is prudent for the Commission to maintain continuous, comprehensive, and vigilant oversight of large utilities like Verizon that provide essential services to millions of Californians.

For the preceding reasons, we will direct ORA to conduct a thorough audit of Verizon covering the period of time of 1999 through 2002. A primary purpose of the audit should be to determine if the information that Verizon reported in its NRF monitoring reports for the years 1999 - 2002 was accurate and reflected Commission regulatory requirements.[97] This will necessarily entail a detailed examination of the information that Verizon provided in its monitoring reports pertaining to its revenues, expenses, assets, liabilities, cash flows, service quality, and affiliate transactions. ORA's audit of information regarding service quality should extend to any reports that Verizon submitted to the FCC that contain information pertaining to service quality in California. In addition, ORA's audit of information regarding affiliate transactions should include an examination of affiliates' books and records.

We expect Verizon to cooperate fully with the audit. For example, Verizon shall (1) comply in a timely manner with ORA's requests for information and documents, and (2) provide ORA with access to any and all documents, whether or not they are monitoring reports filed with the Commission, that are necessary or useful to ORA in conducting its audit. We place Verizon on notice that any failure to cooperate will be subject to monetary penalties and other sanctions.

The Commission is required by Pub. Util. Code § 314.5 to audit Verizon at least every three years. Because ORA's audit report on Verizon that is before us in this proceeding was issued on April 30, 2001, we conclude that ORA should immediately commence the next audit of Verizon in order to meet the statutory requirement of triennial audits.

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[97] A list and description of the 65 monitoring reports that Verizon is required to submit under NRF is contained in Exhibit 103, Volume 4, Schedule 26-1. These reports contain information pertaining to financial results of operations, plant utilization, service quality, and a variety of other matters.

ORA should submit its audit report in the next triennial NRF review. After the audit report is submitted, Verizon and other parties will have an opportunity to respond to the report. The exact dates for the submittal of ORA's audit report and responses will be determined in the next NRF review.

ORA may hire CPAs and other technical experts to conduct all or part of the audit. Any outside experts hired by ORA should perform their work in an objective and independent manner, and have no financial conflicts of interest with respect to Verizon or any of its affiliates. To this end, the part of the audit performed by the hired CPAs should be conducted in accordance with Generally Accepted Auditing Standards (GAAS).[98]

It will be the responsibility of ORA and the Commission to ensure that any CPAs or other technical experts that ORA hires possess the requisite competence, objectivity, and independence. Nothing in this decision authorizes parties outside the Commission to participate in or challenge the selection or oversight of any auditors or technical experts that ORA hires. If any party outside the Commission wishes to challenge the competence, objectivity, or independence of any CPAs or other technical experts that ORA retains, they will have an opportunity to do so only after the audit is complete and only in a docketed proceeding in which the audit findings are considered by the Commission.

Verizon shall reimburse ORA for the cost of the CPAs and technical experts. Verizon may seek to recoup these costs in its annual advice letter

[98] Three principles of GAAS are: (i) the audit must be performed by persons with adequate technical training and proficiency as an auditor; (ii) the auditors must maintain an independent mental attitude on all matters relating to the audit; and (iii) due professional care is to be exercised in the performance of the audit and the preparation of the report.

requesting LE recovery for cost increases or decreases.[99] The audit-related costs included in the advice letter should not exceed the amount billed to Verizon by the Commission or ORA since the last LE advice letter. We place Verizon on notice that it may not recover audit-related costs that are arise from Verizon's failure to cooperate with the audit in a timely and reasonable manner.[100]

ORA should augment the scope of its audit, as appropriate, in response to developments in Phases 2 and 3 of this proceeding. We note that we are currently considering in Phase 2 certain issues arising from the audit of Pacific Bell that was conducted by TD. These issues include allegations that Pacific significantly inflated the costs that it reported during the years of 1997 through 1999 for pensions, post-retirement benefits other than pensions (PBOPs), deprecation, and income taxes. If we determine that any of these allegations have merit, ORA should augment the scope of its audit to determine if the same issues exist for Verizon during 1996 and subsequent years.

In its comments on the Draft Decision, Pacific urges the Commission to wait until Phase 3 to determine the scope of any future audit. Pacific states that depending on the revisions to NRF that are adopted in Phase 3, it may not be necessary to perform a comprehensive audit. We disagree for the previously

[99] Ordering Paragraph 1(g) of D.98-10-026 states as follows: "Advice letters shall be filed every October 1 requesting LE cost recovery for cost increases or decreases resulting from (1) items mandated by the Commission and (2) changes in total intrastate cost recovery resulting from changes between federal and state jurisdictions; alternatively, the advice letter shall state that there are no such adjustments."

[100] Only costs that are reasonable may be recovered as an LE Factor. (D.98-10-026, Fn. 23, Item 9, 82 CPUC 2d 335, 366, 383.) In its comments on the Draft Decision, Verizon states, ominously, that today's decision to convene a penalty phase of this proceeding sends a "strong message to utilities that preservation of rights and a litigious attitude are appropriate, rather than cooperation, disclosure, and compromise…." (Verizon's opening comments, p. 14.) Verizon's comments highlight the need to place Verizon on notice that it may not recover future audit-related costs that are arise from its failure to cooperate with the audit.

stated reasons. Moreover, any changes to NRF adopted in Phase 3 are unlikely to affect the scope of the audit, since such changes are likely to be applied prospectively from the effective date of the Commission's decision in Phase 3, and not retroactively to the period covered by the audit.[101]

Pacific also states in its comments on the Draft Decision that the Commission indicated in its Order establishing this proceeding that it would consider in Phase 3 "the procedures that should be established to provide parties with an opportunity to offer input regarding the scope of the next triennial review."[102] Pacific argues that the Draft Decision frustrates the purpose of Phase 3 by including the results of the newly ordered audit in the next NRF review. We disagree for two reasons. First, parties had ample notice and opportunity to address in Phase 1 the scope and timing of the next audit of Verizon. Second, we are required by Pub. Util. Code § 314.5 to audit Verizon every three years. The next triennial NRF review is the obvious forum to consider the results of the statutorily mandated audit.

VII. ORA's Proposed Memorandum Account

1. Position of the Parties

a. ORA

ORA recommends that the Commission (1) require Verizon to establish a memorandum account to track its earnings above a "benchmark" ROR of 12%, and (2) make the tracked earnings subject to refund pending the conclusion of Phase 3 of this proceeding. ORA states that its proposal is predicated on the high level of Verizon's earnings shown in the following table:

[101] The period covered by audit ordered by today's decision is 1999 through 2002. It is unlikely that any decision will be issued in Phase 3 until sometime in 2003.

[102] Order, p. A-11.

Year	1996	1997	1998	1999	2000	2001
Intrastate ROR [1]	11.84%	12.36%	13.64%	18.67%	14.9%	17.11%
Return on Equity [2]	13.2%	14.9%	17.3%	28.3%	23.6%	30.9%

[1] **Source**: Revised Exhibit 212, W / P 5. Includes all ORA audit adjustments.

[2] **Source**: Exhibit 100, Attachment B. Includes all ORA audit adjustments as well as Verizon's "corrections" for the year 2000 for pension costs and jurisdictional allocations.

ORA asserts that Verizon's high earnings demonstrate that NRF favors shareholders at the expense of ratepayers. ORA declares that making Verizon's high earnings subject to refund is a necessary first step in reforming NRF to properly balance ratepayer and shareholder interests.

In addition to Verizon's high earnings, ORA is concerned about a significant drop in Verizon's intrastate rate base, which decreased by approximately $700 million, or 22%, over a four-year period ending in October 2001. ORA believes that Verizon's high earnings and declining rate base demonstrate that Verizon has been exporting capital from California.

ORA argues that the Commission should disregard the "corrected" RORs that Verizon submitted in this proceeding. ORA states that the "corrections," which significantly reduce the RORs that Verizon previously reported to the Commission, have not been audited and inappropriately exclude all directory revenues beginning in January 2000.

ORA offers two reasons why the appropriate "benchmark" ROR for tracking Verizon's excessive earnings is 12%. First, in D.93-09-038 the Commission adopted a settlement agreement which provides that any party to the settlement that seeks to reinstate sharing shall assume the market-based ROR is 10.5%. ORA argues that because D.89-10-031 set the benchmark ROR 150 basis points above the market-based ROR, the current benchmark ROR is necessarily

12%, or 150 basis points above the market-based ROR of 10.5% adopted in D.93-09-038. Second, in the earnings advice letters that Verizon has filed pursuant to D.98-10-026, Verizon reported a benchmark ROR of 12%. ORA states that the Commission accepted Verizon's reported benchmark ROR of 12% in Resolution T-16572, issued on October 25, 2001.

b. TURN

TURN believes that the Commission's general authority to implement rate reductions obviates the need for ORA's proposed memorandum account to track Verizon's earnings. However, if the Commission finds that it cannot refund excess earnings without first having established a memorandum account, then TURN believes the Commission should implement ORA's proposed memorandum account in order to protect ratepayers.

TURN disputes Verizon's assertions that ORA's proposed memorandum account is prohibited by D.01-06-042. TURN opines that D.01-06-042 actually supports ORA's proposal, since the decision describes the relatively unfettered discretion the Commission has to establish such accounts.[103]

TURN also disagrees with Verizon's contention that OIR 01-12-009 precludes ORA's proposed memorandum account. TURN states that while OIR 01-12-009 addresses "balancing accounts" that serve to "protect utilities from unforeseen expenses of a significant nature over which the utility has no control,[104]" the OIR does not limit the application of memorandum accounts.

c. Verizon

Verizon opposes ORA's proposal to establish a memorandum account to track Verizon's earnings and to make the tracked earnings subject to refund.

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[103] D.01-06-042, *mimeo.*, pp. 6 - 7.

[104] OIR 01-12-009, *mimeo.*, Appendix. A, p. 15.

Verizon states that its earnings have not been unreasonably high as ORA contends. According to Verizon, the RORs it previously reported to the Commission contain two errors. First, Verizon mistakenly accounted for pension costs using Generally Accepted Accounting Principles instead of the Aggregate Cost Method as required by D.88-03-072. Second, Verizon misallocated certain costs and revenues between state and federal jurisdictions. Verizon states that its earnings, when corrected, were as follows:

	1996	**1997**	**1998**	**1999**	**2000**	**2001**
ROR as Reported	11.17	12.10	12.72	17.61	11.39	13.24
Impact of Corrections	(0.89)	(0.52)	(0.39)	(3.04)	N / A	N / A
Impact of Resolved Audit Issues	0.27	0.15	0.20	0.17	0.03	N / A
Revised ROR	10.55	11.75	12.53	14.74	11.42	13.24
Earnings Ceiling ROR	15.50	15.50	15.50	N / A	N / A	N / A

Source: Revised Exhibit 212, W / P 5.

The reported RORs for 2000 and 2001 do not include Yellow Page revenues. In Resolution T-16656, issued on June 27, 2002, the Commission ordered Verizon to file corrected financial monitoring reports that include Yellow Page revenues.

Verizon claims that because the above table shows that its RORs, when corrected, never exceeded the suspended earnings ceiling of 15.5%, there is no merit to ORA's assertion that Verizon's earnings have been unreasonably high.

Verizon contends that ORA's proposed memorandum account is fatally flawed because OIR 01-12-009 and D.01-06-042 limit such accounts to discrete categories of costs or revenues incurred for a specific purpose, not a company’s entire net income.[105] Verizon states that ORA's proposed memorandum account does not target specific events or costs as required by the Commission.

Verizon argues that ORA's proposal erroneously assumes that the benchmark ROR is 12%. Verizon posits that its last benchmark ROR was 13%, as established in D.89-10-031.[106] In D.93-09-038, the Commission eliminated 50-50 sharing of earnings between the benchmark and ceiling RORs. No benchmark ROR was set for Verizon because the parties agreed it was unnecessary.[107] Although Resolution T-16572 recites a market-based ROR of 12%, Verizon opines that such a recital is not binding. Verizon states that because there is currently no benchmark ROR, a new benchmark ROR would have to be litigated rather than arbitrarily set 150 basis points higher than the market-based ROR.

Verizon argues that the Commission cannot make Verizon's earnings subject to refund because doing so would violate the prohibition against retroactive ratemaking embodied in Pub. Util. Code § 728, as interpreted by the California Supreme Court in Pacific Telephone & Telegraph v. Pub. Util. Commission.[108] Verizon asserts that ORA's proposed memorandum account cannot overcome the prohibition against retroactive ratemaking because such accounts are intended to operate prospectively.[109]

Verizon objects to ORA's allegation that Verizon's declining rate base shows that Verizon has been exporting capital. Verizon states that the decline is attributable to (1) the higher depreciation rates employed by Verizon in response to D.98-10-026, which eliminated depreciation reviews, and (2) the aggressive

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[105] OIR 01-12-009, Fn. 7, and D.01-06-042, *mimeo.*, p. 6.

[106] D.89-10-031. *mimeo.*, p. 5.

[107] D.93-09-038, 50 CPUC 2d 684, 689, 690, and 699.

[108] 62 Cal. 2d 634, 44 Cal. Rptr. 1, 1965 Cal. LEXIS 286 (1965).

[109] Southern California Edison Company v. Pub. Util. Commission, 2000 Cal. App. LEXIS 995.

depreciation rates approved by the Commission prior to D.98-10-026. It is these higher depreciation rates, not disinvestment, that led to Verizon's lower rate base. Verizon also testified that its investments have not tapered off, but exceeded $700 million in 2000, a level higher than previous years.

Verizon notes that the Commission in D.93-09-038 adopted a settlement that eliminated sharing between the benchmark and ceiling RORs in exchange for a permanent rate reduction of $53 million. Verizon states that if the Commission adopts ORA's proposal to make Verizon's earnings above the benchmark ROR subject to refund, then the Commission must simultaneously place ratepayers at risk for repaying the $53 million rate reduction.

Finally, Verizon is concerned about the adverse affect that ORA's proposal would have on Verizon's incentive to operate efficiently. Verizon states that for the past three years it has managed all of its operations and decision-making under the NRF rules established by D.98-10-026 with the reasonable expectation that these rules would not be changed prior to the next NRF review. Verizon contends that the Commission has always been careful not to undermine the incentives created by NRF,[110] and it must not do so here. Verizon believes that changing the rules now by holding all or part of Verizon’s earnings subject to refund would create precisely the sort of uncertainty and instability in ratemaking that the NRF regime was designed to prevent.[111]

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[110] See, e.g., D.97-02-049, 1997 Cal. PUC LEXIS 111, *16 (assuring LECs recovery of competitive losses would undermine the incentive NRF was intended to create); D.96-03-020, 1996 Cal. PUC LEXIS 257, *137 (guaranteeing preapproval of local competition implementation costs would negate the incentives created under NRF for the LECs to manage implementation costs efficiently); D.94-06-011, 1994 Cal. PUC LEXIS 456, *104 (Z factor treatment must not reduce the LECs’ incentives to operate efficiently).

[111] Exhibit 300, p. 20

2. Discussion

Verizon's earnings are not subject to refund under current NRF rules. Thus, ORA's proposal to make Verizon's earnings subject to refund would, if adopted, revise NRF. The primary basis for ORA's proposal is ORA's belief that Verizon's earnings are excessive.

Decision 98-10-026 and the Commission's Order instituting this proceeding provide guidance for assessing ORA's proposal. In D.98-10-026, the Commission indicated that it would monitor Verizon's earnings and respond, as appropriate, if Verizon's earnings reached unreasonably high levels.[112] In the Order, the Commission stated that it would not revise NRF in Phase 1 unless the revisions are remedial actions that should be implemented expeditiously.[113] Therefore, in considering ORA's proposal to revise NRF, a key issue is whether Verizon's earnings have reached levels that require immediate remedial action.

The level of Verizon's earnings is a contested issue. For the reasons stated previously in this decision, we conclude that Verizon's reported RORs should be adjusted to reflect (1) ORA's audit findings agreed to by the parties, and (2) excessive directory earnings. We decline to adopt at this time Verizon's “corrections“ for jurisdictional allocations and pension costs. We agree with ORA that the sheer size of the corrections – over 300 basis points in 1999 – indicates that the corrections should not be accepted at face value as Verizon asks, but need to be closely scrutinized. This is especially true in the case of Verizon's “correction“ for jurisdictional allocations, as the record in this proceeding shows that Verizon's allocation of costs is prone to error. Moreover, we are currently considering in Phase 2 of this proceeding the proper regulatory

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[112] D.98-10-026, *mimeo.*, pp. 25, 36, 37, 40, 43, 49, 50, 77, 85, 89, and 92.

[113] Order, Appendix A, p. A-2.

accounting for pension costs. It is premature to accept Verizon's "corrected" pension costs until we reach a decision in Phase 2 regarding the proper regulatory accounting for these costs.[114]

Based on the record developed in Phase 1, we conclude that Verizon's RORs were as follows:

	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Verizon RORs Reported to Commission [1]	11.17	12.10	12.72	17.61	13.96	16.10
Adjustments to Verizon's RORs [1]	0.67	0.26	0.92	1.06	0.94	1.01
Adopted RORs for Verizon	11.84	12.36	13.64	18.67	14.90	17.11
Earnings Ceiling	15.5	15.5	15.5	N / A	N / A	N / A

[1] **Source**: Appendix A. Years 2000 and 2001 include directory revenues pursuant to Resolution T-16656, issued on June 27, 2002.

The above table shows that Verizon's RORs in 1999 and 2001 were 18.67% and 17.11%, respectively, which exceeded the suspended earnings ceiling of 15.5%. These earnings were extraordinarily high for a large public utility providing essential services to millions of Californians, which raises the question of whether the rates that support such high earnings are just and reasonable.

In suspending the earnings ceiling, the Commission did not provide carte blanche for any level of earnings. Rather, the Commission declared that it would monitor Verizon's earnings and respond, as appropriate, if Verizon's earnings

[114] In its comments on the Draft Decision, Verizon states that because its pension costs do not reflect Commission requirements adopted in D.88-03-072, its recorded pension costs must be corrected regardless of any outcome in Phase 2. (Verizon opening comments, p. 5, Fn. 16.) We disagree for the previously stated reasons. Furthermore, the primary issue in Phase 2 regarding pension costs is whether "negative" pension costs should be recorded pursuant to D.88-03-072. If we conclude in Phase 2 that negative pension costs should be recorded, any negative pension costs recorded by Verizon pursuant to this determination could offset much of Verizon's proposed "correction" for pension costs.

reached excessive levels.[115] While Verizon's earnings have reached extraordinary levels, we cannot determine based on the Phase 1 record whether Verizon's high earnings are excessive. We invite parties to address this matter in Phase 3.[116]

Because we are unable to determine at this time if Verizon's earnings are excessive, we conclude that it is inappropriate to make Verizon's earnings subject to refund. In reaching our conclusion, we make no findings regarding the merits of Verizon's arguments concerning are authority to make its earnings subject to refund. Rather, consistent with Verizon's position, we believe that unless and until we make a finding that Verizon's earnings are excessive, it is in the public interest to retain the current NRF rules pending the completion of our review and possible overhaul of NRF in Phase 3.

VIII. Pub. Util. Code § 311(g) – Public Review and Comment

Pub. Util. Code § 311(g)(1) generally requires that a draft decision be served on all parties and subject to at least 30 days of public review and comment prior to a vote of the Commission. The Draft Decision of ALJ Kenney was mailed to the parties on August 6, 2002. Comments regarding the ALJ's Draft Decision were submitted on August 26, 2002, by ORA, Pacific, TURN, and Verizon. These same parties submitted reply comments on September 3, 2002. The parties' comments have been reflected, as appropriate, in the final decision adopted by the Commission.

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[115] D.98-10-026, *mimeo.*, pp. 25, 36, 37, 40, 43, 49, 50, 77, 85, 89, and 92.

[116] Because Verizon's financial reports cannot be relied upon for ratemaking purposes, it will not be possible to make a final determination regarding the precise amount of excessive earnings, if any, until a thorough audit of Verizon's financial reports for the relevant time periods has been completed and reviewed by the Commission. This is unlikely to occur until a subsequent Commission proceeding.

Findings of Fact

1. The purpose of ORA's audit of Verizon was to: (i) analyze NRF monitoring reports; (ii) analyze accounting procedures used to protect against cross subsidization and anticompetitive behavior; (iii) determine if Verizon and its affiliates are following the Commission's rules for affiliate transactions; (iv) determine if Verizon is properly allocating costs to non-regulated activities; and (v) determine if non-structural safeguards adequately protect ratepayer and competitor interests with respect to non-regulated activities.

2. ORA spent relatively little effort on auditing Verizon's regulated activities, which constitute the bulk of Verizon's revenues, expenses, assets, and liabilities.

3. The scope of ORA's audit was limited to the years 1996, 1997, and 1998. Some issues identified in ORA's audit report affect subsequent years.

4. ORA, TURN, and Verizon submitted a Joint Exhibit that (i) identifies and describes all issues in ORA's audit report, and (ii) states whether each issue has been resolved or remains in dispute.

5. The Joint Exhibit identifies a total of 144 issues in the audit report. With the exception of two areas of dispute, the Joint Exhibit resolves all 144 issues.

6. The Joint Exhibit resolves audit issues without a resolution of the factual disputes underlying those issues.

7. The Joint Exhibit requires Verizon to (i) implement new procedures to ensure proper regulatory accounting for affiliate transactions and cost allocations, and (ii) submit restated financial monitoring reports that reflect many of the audit report's findings.

8. Verizon opposes the recommendations in the audit report to (i) require Verizon to submit monitoring reports regarding the extent of local competition and Verizon's market share; (ii) convene workshops to develop these monitoring reports; and (iii) require Verizon to submit the service quality monitoring reports

specified in D.00-03-021 after the requirement to submit these reports terminates in 2004. In the Joint Exhibit, the parties agreed to defer issues (i) and (ii) to Phase 3 of this proceeding, and to defer issue (iii) to Phase 2.

9. Some issues resolved in the Joint Exhibit require further action from one or more of the Joint Parties. These actions are specified on an issue-by-issue basis in the Joint Exhibit.

10. The Joint Exhibit was not sponsored by all of the parties to this proceeding.

11. There was no opposition to the Joint Exhibit or the resolution of audit issues reached in the Joint Exhibit.

12. The Joint Parties reasonably represent all those who have an interest in ORA's audit findings, conclusions, and recommendations.

13. The Commission's rules for affiliate transactions require Verizon to: (i) price all assets, goods, or services sold or transferred to an affiliate at the higher of Verizon's FDC or FMV; (ii) price all assets, goods, or services purchased from an affiliate at the lower of the affiliate's FDC or FMV; (iii) prepare market studies to determine the FMV of transactions between Verizon and an affiliate if the transactions (a) exceed $100,000 per year, or (b) involve assets, goods, or services valued at more than $100,000; and (iv) determine FDC as described in the FCC's Part 64, with the component for return on investment equal to Verizon's Commission-authorized ROR.

14. Joint Exhibit Issue Nos. 13, 16, 18, 25, 33, 36, 44, and 85 pertain to allegations in ORA's audit report that certain transactions between Verizon and its affiliates did not comply with the Commission's rules identified in the previous FOF, resulting in Verizon accruing $13.1 million in higher costs and lower revenues during the period of 1996 through 2001.

15. Verizon's Directory Affiliate publishes White and Yellow Page telephone directories in conjunction with Verizon.

16. In Verizon's last GRC prior to NRF, the Commission reduced Verizon's revenue requirement by $9 million to ensure that the Directory Affiliate did not earn excessive profits at the expense of ratepayers. This $9 million ratemaking adjustment was purportedly included in Verizon's initial rates under NRF.

17. The Directory Affiliate had the following earnings in excess of an ROR of 11.5% that were attributable to Verizon's intrastate operations:
1996: $20.5 million; 1997: $6.2 million; 1998: $35.6 million; 1999: $41.4 million; 2000: $41.4 million; and 2001: $41.4 million.

18. The RORs and sharable earnings that Verizon reported to the Commission did not include the Directory Affiliate's earnings identified in the previous FOF.

19. The Commission’s long-standing policy is to impute excessive directory earnings for ratemaking purposes.

20. The Commission affirmed its policy of imputing excessive directory earnings for ratemaking purposes under NRF in D.01-06-077, Resolution T-16656, and Resolution T-16254.

21. The financial monitoring reports that Verizon previously submitted to the Commission did not comply with the Commission's policy of imputing excessive directory earnings for ratemaking purposes.

22. Decisions 93-09-038 and 98-10-026 and Resolutions T-16680 and T-16656 collectively suggest that it would be appropriate to use an ROR of 10.5% to determine the existence and amount of excessive directory earnings that should be imputed for ratemaking purposes.

23. Verizon's parent company stated in a recent quarterly report to shareholders that its strategy of bundling print and online services has resulted in more revenues for Internet directory services.

24. ORA did not suggest a procedural vehicle for investigating whether revenues from electronic directories should be imputed for ratemaking purposes.

25. ORA's recommended rate reduction of $104 million over a three-year period is equal to the intrastate portion of the misallocated costs and revenues discovered by ORA during its audit.

26. There is no evidence in this proceeding that past or current rates were affected by (i) the misallocated amounts found by ORA's audit, or (ii) the Directory Affiliate's earnings that were improperly withheld from Verizon.

27. There is no evidence in this proceeding that the misallocations were incorporated into (i) cost studies that were previously used by the Commission to set rates, (ii) cost studies that are currently pending before the Commission, or (iii) A.01-02-012 and A.01-12-040 wherein Verizon seeks authority to increase rates for inside wire maintenance, national directory assistance, and operator-assisted calls.

28. Under the earnings-sharing mechanism that was in effect during 1996 -1998, Verizon retained all of its earnings up to the ceiling ROR of 15.5% and refunded to ratepayers any earnings above the ceiling ROR.

29. The Commission's reasons for suspending the earnings-sharing mechanism in D.98-10-026 included the following: (i) to remove the distortion to operating and investment decisions caused by sharing mechanism; (ii) to treat Verizon the same as its competitors; (iii) to place Verizon at risk for all operating and investment decisions; and (iv) the earnings-sharing mechanism provides little benefit to ratepayers, since none of Verizon's earnings had been refunded to ratepayers since 1993.

30. Under the NRF floor mechanism in effect during 1996 – 1998, Verizon could petition for reconsideration of the adopted inflation or productivity factors if its ROR fell below 7.75% for two years in a row.

31. After the floor mechanism was suspended by D.98-10-026, Verizon could still file an application for a general rate increase if its ROR fell precipitously.

32. The Commission's reasons for suspending the productivity factor in D.98-10-026 included the following: (i) the factor was inappropriate in an environment of increasing competition, and (ii) Verizon's earnings during 1996 and 1997 indicated that the previous suspension of the productivity factor did not result in Verizon's accumulation of financial resources to gain an unfair competitive advantage.

33. The Commission's decision in D.98-10-026 to suspend the earnings-sharing mechanism and the productivity factor relied, in part, on Verizon's reported earnings.

34. ORA's audit report establishes a strong case that Verizon did, in fact, subsidize unregulated activities. There is no evidence in Phase 1 of this proceeding that ratepayers were harmed by these subsidies.

Conclusions of Law

1. The Joint Exhibit inappropriately defers to Phase 2 of this proceeding the issue of whether Verizon should be required to submit the service quality monitoring reports specified in D.00-03-021 after the requirement ends in 2004. The Joint Exhibit should be modified so that this matter is addressed in Phase 3 where the Commission will consider revisions to the NRF monitoring program.

2. The Joint Exhibit, with the modification described in the previous Conclusion of Law (COL), is reasonable in light of the whole record, consistent with the law, and in the public interest.

3. The complete Joint Exhibit contained in Exhibit 107 should be adopted with the modification described in COL No. 1.

4. The Joint Parties should undertake and complete in a timely fashion the actions required by the Joint Exhibit.

5. Verizon should provide a complete copy of the Joint Exhibit to any person or entity that requests a copy.

6. The Joint Exhibit that is adopted by today's decision is part of a Commission decision. Therefore, if Verizon does not fulfill its obligations under the Joint Exhibit in a timely fashion, it will be subject to monetary penalties and/or other sanctions.

7. Telephone directories are an integral part of telephone service.

8. Pub. Util. Code § 728.2(a) requires the Commission to consider directory earnings when setting rates for telephone service.

9. Decision 89-10-031 required directory revenues, expenses, and excess profits to be included in the NRF earnings-sharing mechanism.

10. NRF incorporated the Commission's long-standing practice of imputing excessive directory earnings for ratemaking purposes.

11. In D.91-07-056, the Commission held that the determination of Verizon's sharable earnings should exclude the “ratemaking adjustment“ for excessive directory earnings whereby all directory earnings in excess of the utility's Commission-authorized ROR were flowed through to ratepayers in the form of lower rates. The decision did not exclude the excessive directory earnings themselves from the determination Verizon’s of sharable earnings.

12. Nothing in D.91-07-056 gives any indication that the Commission intended to modify or reverse the clear directive of D.89-10-031 to include directory earnings in sharable earnings.

13. Long-standing Commission policy, D.91-07-056, and D.89-10-031 together require that excessive directory earnings be included in the determination of Verizon's ROR and sharable earnings. Thus, during the audit period of

1996 - 1998, ratepayers were to share in excessive directory earnings to the extent these earnings, when combined with Verizon's earnings from its regulated telephone operations, exceeded the ceiling ROR of 15.5%.

14. The Directory Affiliate's excessive earnings shown in Appendix B of this decision should be used in the determination of (i) Verizon's ROR, and (ii) Verizon's sharable earnings during the audit period of 1996 – 1998.

15. Verizon should file revised financial monitoring reports for every year beginning with 1996 that reflect all earnings from the publication of White and Yellow Page directories that are associated with California intrastate operations. Verizon should continue to file such reports until further notice.

16. The scope of Phase 3 should be revised to include consideration of whether the appropriate ROR for determining excessive directory earnings in the future should be 10.5%, 11.5%, or some other ROR.

17. The FCC's rules provide that states may impute directory earnings for state ratemaking purposes.

18. With limited exceptions, the Commission does not apply its rules governing affiliate transactions to directory affiliates.

19. Verizon should not be required at this time to conduct studies for the purpose of determining if transactions with the Directory Affiliate involving directory revenues and / or earnings are priced at the lower of cost or market.

20. The Directory Affiliate's electronic directories benefit from their affiliation with traditional printed directories. Ratepayers, not just shareholders, should benefit from this affiliation.

21. Any success enjoyed by electronic directories that is attributable to their affiliation with traditional printed directories might erode revenues from the traditional directories and thereby diminish the financial support that traditional

directories provide to basic telephone service. If this were to occur, ratepayers would be harmed by the affiliation and should be compensated for the harm.

22. Verizon has not demonstrated any flaws in the Commission's rules governing affiliate transactions that need to be remedied at this time.

23. As a matter of general policy, the Commission does not revise its rules for affiliate transactions through piecemeal changes that affect only one utility as Verizon proposes to do here. Rather, it is the Commission's general policy to apply a uniform set of rules to all utilities in order to promote administrative efficiency and to treat all utilities equally and fairly.

24. Verizon's proposed revisions to the Commission's rules governing transactions between Verizon and its affiliates should not be adopted at this time for the reasons set forth in the two previous COLs.

25. Except for transactions with its Directory Affiliate, Verizon should continue to be required to conduct market studies for all affiliate transactions valued at more than $100,000.

26. If ratepayers are placed at significant risk of paying higher rates because costs or revenues are misallocated between a utility and its affiliates, this would constitute the type of management misconduct described in D.89-10-031 and D.91-07-056 that would warrant a rate reduction under NRF.

27. Based on the record developed in Phase 1 of this proceeding, there was little risk that the misallocations, when corrected, could have affected rates through the NRF earnings-sharing mechanism.

28. Because the Commission has not yet reviewed the forward-looking cost studies that Verizon submitted pursuant to D.96-08-021, it is remotely possible that the misallocations are reflected in these studies and could have affected rates had the misallocations not come to light in this proceeding.

29. It is remotely possible that Verizon might have submitted cost studies sometime in the future that included the misallocations had the misallocations not come to light in this proceeding.

30. There was little risk of Verizon filing an application for a rate increase under the floor mechanism during 1996 – 1998 that included the misallocations, because Verizon's earnings never approached the floor ROR during that period.

31. Given Verizon's strong earnings since D.98-10-026, there was little risk that Verizon might have filed an application for a general rate increase, either in the past or the foreseeable future, that included the misallocations.

32. If the Commission had known of the misallocations when it issued D.98-10-026, it is unlikely this knowledge would have altered the Commission's decision in D.98-10-026 to suspend the sharing mechanism and productivity factor because: (i) the misallocations, when corrected, did not increase Verizon's earnings above the sharing threshold, and (ii) the misallocations are unrelated to the Commission's other reasons for suspending the sharing mechanism and productivity factor.

33. In order for cross-subsidization to harm ratepayers directly, the subsidies must be reflected in rates.

34. For the reasons set forth in the body of this decision, there was little risk of the misallocations being included in rates and thereby causing direct harm to ratepayers.

35. The misallocations caused no actual harm to ratepayers and never posed more than a small risk of harm to ratepayers.

36. In the absence of actual harm or significant risk of harm to ratepayers, it is unreasonable to adopt ORA's proposal to reduce Verizon's rates by $104 million.

37. Today's decision regarding ORA's proposed rate reduction for Verizon in no way prejudges how the Commission will rule in Phase 2 of this proceeding regarding ORA's proposed rate reduction for Pacific Bell.

38. The record of this proceeding establishes a strong case that Verizon did not account for affiliate transactions and excessive directory earnings in accordance with the Commission's rules, causing Verizon to accrue $199 million in higher costs and lower revenues during the period of 1996 through 2001 as set forth in Appendix B of this decision.

39. It is imperative that Verizon provide the Commission with accurate information so that the Commission can make informed decisions affecting millions of Californians.

40. Parties should be allowed to present proposals in Phase 3 for revising NRF in ways that would deter NRF utilities from (i) violating the Commission's rules for affiliate transactions, (ii) violating the Commission's rules regarding imputation of directory earnings, and/or (iii) submitting inaccurate information to the Commission.

41. ORA should conduct a thorough audit of Verizon covering the years 1999 through 2002. The scope of the audit should include, but not be limited to, a detailed examination of all NRF monitoring reports that Verizon submitted to the Commission for the years 1999 through 2002 for the purpose of determining if Verizon reported information accurately and in accordance with Commission requirements. This will necessarily entail close scrutiny of the information that Verizon provided in its monitoring reports pertaining to revenues, expenses, assets, liabilities, cash flows, service quality, and affiliate transactions.

42. In order to verify the information that Verizon included in its NRF monitoring reports regarding service quality, ORA's audit should include an

examination of any reports that Verizon submitted to the FCC that contain information pertaining to service quality in California.

43. In order to verify the information that Verizon included in its NRF monitoring reports regarding affiliate transactions, ORA' audit should include an examination of affiliates' books and records.

44. The scope of ORA's audit should include an examination of the electronic publishing activities of Verizon's affiliates for the purpose of identifying and, to the extent possible, quantifying (a) the benefits that traditional printed directories provide to electronic publishing, and (b) any actual or potential loss of revenues incurred by traditional directories due to their affiliation with electronic publishing.

45. Verizon and its affiliates should afford ORA access to any and all documents, regardless of whether they are monitoring reports filed with the Commission, that are necessary or useful to ORA in carrying out its audit.

46. ORA should be authorized to hire CPAs and other technical experts to conduct any part of the audit identified in the previous COL. Any outside experts hired by ORA should (i) perform their work in an objective and independent manner, and (ii) have no financial conflicts of interest with respect to Verizon or any of its affiliates. The part of the audit performed by outside CPAs should be conducted in accordance with GAAS.

47. Verizon should reimburse ORA for the costs that ORA incurs to hire CPAs and other technical experts. Verizon should be allowed to seek recovery in its annual LE advice letter the amount billed to Verizon by the Commission or ORA since the last LE advice letter.

48. It will be the responsibility of ORA and the Commission to ensure that any CPAs or other technical experts hired by ORA possess the requisite competence, objectivity, and independence. If any party outside the Commission

wishes to challenge the competence, objectivity, or independence of any retained CPAs or other technical experts, their opportunity to do so will be after the audit is complete and in the context of a docketed proceeding in which the audit findings are considered by the Commission.

49. Verizon should cooperate fully with the audit that ORA is directed to undertake pursuant to this decision, including responding to requests for information and the production of documents in a timely fashion. Failure to cooperate should subject Verizon to monetary penalties and/or other sanctions.

50. Although Verizon is required to pay for the cost of the audit ordered herein, the Commission may deny Verizon authority to recover audit-related costs that arise from Verizon's failure to cooperate with the audit in a reasonable and timely manner.

51. The Commission is required by Pub. Util. Code § 314.5 to audit Verizon at least every three years. ORA should immediately commence the next audit of Verizon in order to meet this statutory requirement.

52. ORA should submit its audit report in the next triennial NRF review. Verizon and other parties should have an opportunity to respond to the audit report. The exact dates for the submittal of ORA's audit report and responses to the report should be determined in the next NRF review.

53. ORA should augment the scope of its audit, as appropriate, in response to developments in Phases 2 and 3 of this proceeding.

54. The Commission will consider in Phase 2 allegations that Pacific Bell reported inflated costs during 1997, 1998, and 1999 for pensions, PBOPs, deprecation, and income taxes. If the Commission determines that any of these allegations have merit, ORA should augment the scope of its audit to determine if the same issues existed for Verizon during 1996 and subsequent years.

55. For the reasons set forth in the body of this decision, the earnings that Verizon previously reported to the Commission should not be revised at this time to reflect Verizon's proposed corrections for (i) pension costs, and (ii) misallocations between federal and state jurisdictions.

56. The earnings that Verizon previously reported to the Commission should be revised to reflect (i) ORA's audit adjustments agreed to by the parties, and (ii) excessive directory earnings attributable to California intrastate operations.

57. The record in Phase 1 indicates that Verizon's RORs were as follows: 1996: 11.84%; 1997: 12.36%; 1998: 13.64%; 1999: 18.67%; 2000: 14.90%; and 2001: 17.11%.

58. Verizon's RORs for 1999 and 2001 were extraordinarily high for a large public utility serving millions of Californians. This raises the question of whether the rates that support such high earnings are just and reasonable.

59. Pursuant to D.98-10-026, the Commission may take remedial action if Verizon's earnings reach unreasonably high levels.

60. There is an inadequate record in Phase 1 of this proceeding to determine if Verizon's high earnings are excessive.

61. ORA's proposal to make Verizon's allegedly excessive earnings subject to refund and to require Verizon to track its earnings in a memorandum account should not be adopted at this time.

62. The scope of Phase 3 should be revised in include the issue of whether Verizon's earnings are excessive.

63. A final determination regarding the actual amount of Verizon's excessive earnings, if any, should not be made until a thorough audit of Verizon's financial monitoring reports for the relevant time periods has been completed and reviewed by the Commission. This is unlikely to occur until a subsequent Commission proceeding.

64. The following order should be effective immediately so that its provisions may be implemented expeditiously.

INTERIM ORDER

IT IS ORDERED that:

1. The Joint Exhibit resolving most audit issues that is contained in Exhibit 107 is adopted with the modification identified in Ordering Paragraph 2.

2. The adopted Joint Exhibit is modified so that Phase 3 is designated as the venue for considering the Office of Ratepayer Advocates' (ORA's) proposal to require Verizon California Incorporated (Verizon) to submit the service quality monitoring reports specified in Decision 00-03-021 after the requirement terminates in 2004.

3. The parties to the Joint Exhibit shall undertake those actions specified in the Joint Exhibit in the manner and time frames set forth in the Joint Exhibit.

4. Verizon shall provide a complete copy of the adopted Joint Exhibit to any person or entity that requests a copy.

5. All excessive directory earnings that are described in the body of this Order shall be imputed for the purpose of determining Verizon's (i) intrastate rates of return, and (ii) sharable earnings during the period of 1996 through 1998.

6. Verizon shall file revised financial monitoring reports for every year beginning with 1996 that reflect all excessive directory earnings attributable to Verizon's California intrastate operations. Verizon shall continue to file financial monitoring reports that all reflect excessive directory earnings until further notice from the Commission.

7. Except for transactions involving directory revenues and / or earnings, Verizon shall conduct market studies for all affiliate transactions valued at more than $100,000.

8. ORA shall immediately commence a comprehensive audit of Verizon covering the years 1999 through 2002. The audit shall include (i) a thorough examination of all monitoring reports that Verizon submitted to the Commission under the New Regulatory Framework (NRF), (ii) an investigation of the electronic publishing activities of Verizon's Directory Affiliate, and (iii) such other matters as more fully described elsewhere in this Order. ORA may augment the scope of the audit, as appropriate, in response to developments in Phases 2 and 3 of this proceeding.

9. In Phase 2 the Commission is currently considering allegations that Pacific Bell Telephone Company inflated the costs that it reported during the years of 1997 through 1999 for pensions, post-retirement benefits other than pensions, deprecation, and income taxes. If the Commission determines that any of these allegations have merit, ORA shall augment the scope of its audit to determine if the same issues exist for Verizon during 1996 and subsequent years.

10. ORA shall submit its audit report in the next triennial review of NRF for Verizon. Verizon and other parties shall have an opportunity to respond to the report. The exact dates for the submittal of ORA's audit report and responses to the report will be determined in the next triennial review of NRF for Verizon.

11. ORA may hire Certified Public Accountants (CPAs) and other technical experts to conduct all or part of the audit required by this Order.

12. Any outside experts hired by ORA shall (i) perform their work in an objective and independent manner, and (ii) have no financial conflicts of interest with respect to Verizon or any of its affiliates. The part of the audit performed by outside CPAs shall be conducted in accordance with Generally Accepted Auditing Standards.

13. Verizon shall reimburse ORA for the costs that ORA incurs to hire CPAs and other technical experts. Verizon may seek to recover these costs in its annual

advice letter requesting limited exogenous (LE) recovery for cost increases or decreases. The audit-related costs included in the advice letter shall not exceed the amount billed to Verizon by the Commission or ORA since Verizon's previous LE advice letter.

14. Verizon shall cooperate fully with ORA's audit.

15. Verizon shall not recover audit-related costs that are incurred due to Verizon's failure to cooperate with the audit in a reasonable and timely manner.

16. The scope of Phase 3B is revised to include consideration of the following: (i) any proposals submitted by the parties to revise NRF in ways that would deter NRF utilities from (a) violating the Commission's rules for affiliate transaction, (b) violating the Commission's rules regarding the imputation of directory earnings, and/or (c) submitting inaccurate information to the Commission; (ii) whether the appropriate ROR for determining excessive directory earnings in the future should be 10.5%, 11.5%, or some other ROR; and (iii) whether Verizon's earnings are excessive. A final decision regarding the amount of Verizon's excessive earnings, if any, will not be made until thorough audits of the relevant financial monitoring reports have been completed and reviewed by the Commission.

This order is effective today.

Dated October 3, 2002, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
CARL W. WOOD
GEOFFREY F. BROWN
MICHAEL R. PEEVEY
Commissioners

Appendix A

Verizon's Intrastate Rates of Return

	1996	1997	1998	1999	2000	2001
ROR Reported to the Commission [1]	11.17	12.10	12.72	17.61	13.96	16.10
ROR Impact of Resolved Audit Issues (Including I-factor) [2]	0.27	0.15	0.20	0.17	0.03	0.00
ROR Impact of Excessive Directory Earnings [2]	0.40	0.11	0.72	0.89	0.91	1.01
Total:	11.84	12.36	13.64	18.67	14.90	17.11

[1] **Source**: Revised Exhibit 212, W / P 5. See also Resolution T-16680, issued on August 22, 2002, that contains Verizon's reported ROR for the year 2001. Years 2000 and 2001 include directory revenues pursuant to Resolution T-16656, issued on June 27, 2002.

[2] **Source**: Revised Exhibit 212, W / Ps 1 and 5.

Appendix B

Summary of Higher Costs and Lower Revenues Caused by Improper Accounting for Excessive Directory Earnings and Affiliate Transactions

	1996	1997	1998	1999	2000	2001	Total
Improper Accounting	**($000)**	**($000)**	**($000)**	**($000)**	**($000)**	**($000)**	**($000)**
Joint Exhibit Issue 13	$8,429	$0	$0	$0	$0	$0	$8,429
Joint Exhibit Issue 16	$0	-$1,014	-$47	$0	$0	$0	-$1,061
Joint Exhibit Issue 25	$0	$1,844	$0	$0	$0	$0	$1,844
Joint Exhibit Issue 33	$162	$85	$145	$0	$0	$0	$392
Joint Exhibit Issue 36	$263	$265	$801	$330	$468	$0	$2,127
Joint Exhibit Issue 44	-$50	$262	$38	-$6	$467	$134	$845
Joint Exhibit Issue 85	$11	$324	$195	$0	$0	$0	$530
Subtotal	$8,815	$1,766	$1,132	$324	$935	$134	$13,106
Excessive Directory Earnings	$20,500	$6,200	$35,600	$41,358	$41,358	$41,358	$186,374
Total	**$29,315**	**$7,966**	**$36,732**	**$41,682**	**$42,293**	**$41,492**	**$199,480**

** Source: Revised Exhibt 212. All amounts are intrastate and pre-tax. Does not include adjustments to rate base or the rate-base effects of the above adjustments.

Appendix C

Salient Portions of the Adopted Joint Exhibit